PUBLIC FINANCE

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INTRODUCTION TO THE SERIES

The Theory of Economics does not furnish a body of settled conclusions immediately applicable to policy. It is a method rather than a doctrine, an apparatus of the mind, a technique of thinking, which helps its possessor to draw correct conclusions. It is not difficult in the sense in which mathematical and scientific techniques are difficult; but the fact that its modes of expression are much less precise than these, renders decidedly difficult the task of conveying it correctly to the minds of learners.

Before Adam Smith this apparatus of thought scarcely existed. Between his time and this it has been steadily enlarged and improved. Nor is there any branch of knowledge in the formation of which Englishmen can claim a more predominant part. It is not complete yet, but important improvements in its elements are becoming rare. The main task of the professional economist now consists either in obtaining a wide knowledge of *relevant* facts and exercising skill in the application of economic principles to them, or in expounding the elements of his method in a lucid, accurate and illuminating way, so that, through his instruction, the number of those who can think for themselves may be increased.

This Series is directed towards the latter aim. It

is intended to convey to the ordinary reader and to the uninitiated student some conception of the general principles of thought which economists now apply to economic problems. The writers are not concerned to make original contributions to knowledge, or even to attempt a complete summary of all the principles of the subject. They have been more anxious to avoid obscure forms of expression than difficult ideas, and their object has been to expound to intelligent readers, *previously unfamiliar* with the subject, the most significant elements of economic method. Most of the omissions of matter often treated in textbooks are intentional, for as a subject develops, it is important, especially in books meant to be introductory, to discard the marks of the chrysalid stage before thought had wings.

Even on matters of principle there is not yet a complete unanimity of opinion amongst professors. Generally speaking, the writers of these volumes believe themselves to be orthodox members of the Cambridge School of Economics. At any rate most of their ideas about the subject and even their prejudices, are traceable to the contact they have enjoyed with the writings and lectures of the two economists who have chiefly influenced Cambridge thought for the past fifty years, Dr Marshall and Professor Pigou.

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CHAPTER I

EXPENDITURE AND REVENUE

§ 1 *Introductory* Wherever an organised political society has existed funds have been needed to defray the costs of government, for the administration of any government involves expense As societies have advanced the tendency has been for the duties of their Governments to increase both in number and in cost, and in consequence of this Government expenditure has increased This tendency became much more marked in the period 1890–1914 and at the end of that time the public expenditure of every progressive State had reached considerable proportions In the years 1914–18 the enormous costs of the war caused an unparalleled increase in Government spending in all the belligerent states

After the making of peace the public expenditure of these countries remained far above their pre-war level Great public debts had been accumulated during the war, the annual interest on which in many countries far exceeded the whole of their pre war expenditure, as, for instance, in England, where the National Debt

charges in 1920 were nearly double the total public expenditure in 1913, and where the Government was committed to further heavy charges on behalf of War Pensions Apart from the burden of war debts public expenditure had increased since 1914, partly because of the increased cost of discharging the old duties of the Governments and partly because of the new demands for Government help which arose on every side both during the war and during the difficult period of transition from war to peace Neutral as well as belligerent states were affected by the two last causes

In the years after the war nearly every country was faced with the problem of finding public revenues greater than those needed in the pre war years—in some cases many times as large as the pre war revenues This increase in the scale of Government finance gave the whole question a new importance Both the raising and the spending of the greater revenues were affecting people to an extent that they had never experienced before The heavier taxation and higher prices imposed heavy burdens and had a vital effect upon every branch of economic activity On the other hand, the increased Government spending meant a large increase in the number of those directly affected by such spending, either as holders of interest-bearing Government stock, as Government employees or as recipients in one way or another of assistance from public funds and this too had an important effect upon economic prosperity It is with some of the economic problems arising out of the raising and spending of public revenues that this book is concerned

§ 2 *Methods of Raising Revenue* A Government may obtain its revenues in various ways First State-owned property may yield an income which can be used for public purposes and many countries have in the past derived substantial revenues in this way There are, however few countries in which it now yields more than an insignificant part of the necessary funds

Secondly a Government may raise money by means of loans, and this method was extensively used by belliger ent states during the war Borrowing can, however, never afford a final solution of a country's financial problems, for borrowing implies interest and ultimate repayment It is now generally recognised that the State, as the individual, cannot hope to remain solvent if borrowing is used to meet recurring expenditure, and the use of borrowing can only be justified in cases of exceptional emergency

Thirdly, a Government may carry on a commercial or industrial undertaking selling its products at a price covering their cost, and possibly making an additional profit which can be used as general revenue In pre war days, Prussia made a substantial revenue from her State railways, and in this country the Post Office yielded a surplus which was used to meet part of the other expenses of the State

The last important method of raising revenue, and the one on which modern governments have come to rely more and more as the means of raising the bulk of their ordinary revenue, is taxation

§ 3 *Taxation and Expenditure* Taxation has been defined as a "compulsory exaction by the State of a

part of the wealth of individuals for public purposes" It follows from this definition that the first result of a tax is to reduce the power of the individual taxpayer to spend or to save for, when a man compulsorily pays a certain part of his wealth to the State, he must, other things being equal reduce his private expenditure or his investments by a corresponding amount Taxation, however in so far as it is successful, does not destroy wealth, but transfers the control of it from private individuals to the State—so that while taxation reduces the power of the taxpayers to spend or save as private individuals it increases their power to spend or save collectively through the Government

Wherever Government undertakes new expenditure the funds for which are raised by taxation, these funds must, in the first instance, come out of the pockets of the taxpayers (the only source of taxation is the wealth of individuals) and the extension of collective spending on the part of the Government means other things being equal, a contraction of private spending Whether the country will lose or gain by such a proceeding depends upon whether the loss from the reduced private expenditure is greater or less than the gain from the new collective expenditure In considering this, we have to take into account the effect of the State expenditure both upon the amount of wealth produced in the country and upon the way in which the wealth is distributed between different members of society

§ 4 *Productive Expenditure* There are various kinds of State expenditure which may be expected to increase the wealth producing capacity of a country A govern

ment may undertake the provision of goods and services which although they would otherwise be provided by private enterprise, can be provided most economically by the State Cases of this kind can occur only where the State has special advantages as a producer—when, for instance, there are special advantages to be gained from centralised management, and when Government administration is as efficient as private administration The number of undertakings of this kind carried on by governments at the present time is small—and they are mainly connected with communication or transport

There are however, some undertakings which although they would not be undertaken, or undertaken in the same way, by private enterprise may yet increase the national productivity Expenditure on railways in a sparsely populated country might not tempt the private investor as it would be years before such an undertaking would pay its own way, but such expenditure might lead ultimately directly and indirectly, to an enormous increase in the prosperity of the community and might from the point of view of the country as a whole prove an extremely good investment In 1909 a Development Fund was established under the control of the Treasury and a Development Commission was appointed to consider the possibility of making grants from the fund for such productive purposes as the promotion of agriculture afforestation and reclamation of land, rural transport, harbours or, in short, any purpose calculated to promote the economic development of the United Kingdom ' This was a recognition of the fact that expenditure on the development of natural resources might in certain conditions be to the

interest of the country, although the return might not be direct enough or rapid enough to attract private investors As a matter of fact the actual expenditure of this kind which was undertaken before 1914 in the United Kingdom was small

The years before the war saw a considerable increase in nearly all progressive countries of that part of State expenditure which may be regarded as invested in the human resources of the nations Under this head may be included all educational expenditure and expenditure on public health—for anything raising the level of physical and mental efficiency may be expected to increase ultimately the productive capacity of the community Also under this head would come expenditure on the administration of legislation intended to prevent the wasteful use of the human capital of the country—such, for instance as all kinds of factory legislation and legislation regulating the conditions of employment of children There is reason to believe that legislation limiting the hours of work in factories for women and children had a favourable effect upon production by preventing physical deterioration through systematic overwork Any legislation protecting health is likely to save in so far as it is effective Results of this kind are probably most important of all in the case of legislation protecting children from exploitation which might impair their whole future efficiency

Before the war the tendency to increasing social expenditure was sufficiently rapid to be a cause of considerable alarm to those who dreaded the effects of the heavier burdens of taxation necessary to meet it Its justification apart from the increasing sense of re

sponsibility to the less fortunate members of society, lay in the belief that most of the expenditure was likely ultimately to prove reproductive even from the revenue point of view for in so far as it succeeded in raising the level of physical and mental efficiency in the nation it might be expected to lead to greater production of wealth and to create new sources of revenue to meet the higher taxes Such results would, of course, only show themselves slowly and would probably always be difficult to measure

Any State expenditure, then, which directly or indirectly develops the natural or human resources of the nation or leads to their more economical use may be expected to increase national prosperity by increasing the national wealth, and may thus be expected ultimately to "pay for itself"—given the important qualification that the gain due to the increased expenditure is not less than the loss caused by the heavier taxation

Mahcbad Vorsity

§ 5 *Unproductive Expenditure* The greater part of State expenditure to day cannot be expected either directly or indirectly to develop productive capacity In expenditure on war belligerent states turn their resources from production to actual destruction of the material and human resources of one another Even if one nation may hope for aggrandisement—and recent experience seems to show that in modern warfare, at least this is a vain hope—humanity as a whole must find itself poorer as a result of the destruction In expenditure on armaments in peace time wealth is used not to develop existing or new sources of wealth, but merely to protect existing wealth

To make a distinction between wealth used for defence and wealth used for production it may be argued is necessarily artificial—for given the past and existing state of international politics, such expenditure is necessary to guarantee the security essential for any economic development There is much truth in this A nation must secure itself against attack just as much as a private business man must secure himself against burglary but it is also true that if a business man spends half his wealth on burglary insurance there will only be half as much wealth left to burgle, and if a country spends a large part of its wealth on defence there must other things being equal, be less wealth left to defend In neither case can the money spent on insurance or defence be expected to add to future production Further, if the insurance charges in the case of the business man are so heavy that he is crippled for want of capital, the development of his business will be injured, and not only will part of his present wealth be absorbed by the insurance, but his whole future prosperity will be checked And it is equally true that if taxation absorbs for purposes of defence wealth that would otherwise be used in developing either the industrial or human resources of the country, the future productivity of the country must be reduced Or, to put the matter from the purely revenue point of view, the effect of the heavy taxes will be to cut off part of the supplies of wealth out of which the taxes of the future will have to be met When the cost of burglary insurance became intolerably heavy, the private individual would probably begin to look round for other means of providing against such eventualities, and

when the cost of defence begins to have a serious effect in reducing wealth production, there would seem to be every incentive to a country wishing to maintain its economic prosperity to find other means of maintaining its security

War expenditure is not the only kind of State expenditure which may be regarded as unproductive Expenditure on the administration of justice can hardly be called reproductive in the economic sense Some social expenditure, such, for instance as Old Age Pensions, can hardly be expected to prove reproductive, for Old Age Pensioners are not likely to contribute appreciably to production The emphasis laid on war expenditure is not due to the fact that it differs from other unproductive expenditure, but that expenditure on war, and on the preparation for war and the payment of interest on debts accumulated during past wars still form enormously the most important items in the budgets of most modern states

Even before 1914 armament expenditure was increasing rapidly In England in 1913 it stood at twice as much as in 1893 It then absorbed two fifths of the total expenditure and was more than twice the whole expenditure on the social services In the United States the expenditure increased from \$86 m in 1895 to \$243 m in 1914 (These figures do not include interest on the National Debts which had been mainly the results of war expenditure)

In the years after the Armistice these burdens were far heavier The interest on the new war debts the payment of War Pensions and the increased expenditure on armaments even in the peace years meant an

enormous increase in the absolute amount of expenditure under these heads We shall show later that the loss to a country through heavier taxation is likely to increase not in proportion, but more than in proportion to the increase in taxation—while the burden of the same amount of taxation is likely to be heavier in a poor than a rich country The burden of greatly increased taxes in countries already impoverished by war is likely to be extraordinarily heavy

The fact that Government expenditure does not lead to any increase in economic prosperity is no final reason for condemning it How far a country may be justified in making any sacrifice to maintain its national independence, to fulfil its treaty obligations, to increase its territorial possessions or even to punish its national enemies are political questions which can never be reduced to purely economic terms There are many other forms of Government expenditure which can never be judged simply by their effect on economic prosperity Expenditure on the administration of justice is a case in point, if much social expenditure could be shown definitely to be economically unreproductive, probably most modern communities would maintain much of it on humanitarian and charitable grounds, while, in a democratic community at least, a political case could be made out for a good general education, even if it could be shown that educational expenditure showed no practical economic return We are, however only concerned with the economic effects of such expenditure, and the point to emphasise is that when taxation transfers wealth from private individuals to the State the taxation must reduce the power of those taxed

to spend or to save Where the wealth absorbed in this way reduces their power to make expenditure necessary for efficiency or to invest in productive industry then taxation will reduce the future production of wealth Where there is no counterbalancing economic gain from the Government expenditure, this must mean a reduction in the economic prosperity of the community

§ 6 *State Expenditure and Distribution* State expenditure, as well as altering the total production of a community may, as we have said, have an important effect in changing the way in which wealth is distributed between different members of the community It may do this in various ways The most direct is probably when revenue is raised by taxation of one class and paid out in the form of money to another The same result may be achieved more indirectly when wealth is raised by the taxation of one class and the revenue is used on providing goods or services which also benefit, or possibly only benefit, other classes When the State undertakes expenditure which does not yield any direct return—e g the cost of defence—if the cost of that expenditure is imposed mainly on certain classes it will mean that the net money incomes (i e income minus tax) of those classes will be reduced as compared with the income of other classes

A case approximating to the first occurred in the United Kingdom in 1906 when the Government introduced a scheme of Old Age Pensions to those who—given certain conditions—were over seventy years of age and whose incomes were less than £30 a year, and

raised the increased revenues necessary by increasing the taxation on estates passing at death This was in effect a transference of wealth from the estates of the richer classes to the aged poor Such direct transference is on the whole unusual The more usual method is to transfer indirectly by providing free goods and services to people who have not borne either any part of or the whole burden of their cost From 1906 until the outbreak of war there was a steady increase of expenditure in the United Kingdom on what were called the "social services expenditure on education, on national health insurance and on the attempts to prevent and remedy the evils of unemployment The people who benefited primarily from such expenditure were the manual workers—but the increased revenue needed during the period both for this and other expenditure came mainly from increased income tax and increased death duties The first did not touch those with incomes of less than £160 a year and the second did not fall on those who left less than £100 at death There can be little doubt that the effect of such taxation and expenditure was to cause some transference of wealth from the wealthier to the poorer classes

As an illustration of the third case we may take the example of the United Kingdom during the war years The increased expenditure between 1913–14 and 1918–19 was mainly although of course not exclusively, due to war expenditure of different kinds In 1913 it is calculated that the net income of people whose earned income was £150 a year was reduced by taxation to £142 15s, the net income of people who earned £50,000 a year was reduced by taxation to £45 200 As a result

of the increased taxation in the last war year, 1918–19, the net income of people earning £150 a year was reduced to £133 10s, while the net income of those earning £50 000 was reduced to just less than a half, i e £24,700 a year The result of such taxation must be to reduce—other things being equal—the difference between the net money incomes of the rich and of the poor

At the present time there is much to be said for reducing the great existing inequalities of wealth As a man's wealth increases the satisfaction he gets from further increases in wealth tends to diminish The loss of £100 means less to a man with £10,000 than to a man with £1000 a year and enormously less than to a man with only £150 a year To take £100 from a wealthy man and to give them to a poor man is to take them from some one who will feel their loss little and to give them to some one who is likely to benefit greatly Given this it may be argued anything that tends to make the distribution of wealth more equal will tend to increase the amount of satisfaction derived from the same amount of wealth It will increase the economic prosperity of the community, because—although not increasing the total amount of wealth—it will increase the satisfaction obtained from it by improving its distribution

The great danger of attempted re distribution is always that it may check the production of wealth A better distribution of the same amount of wealth may be desirable but if the effect of this is that in the future there will be a smaller supply to distribute the case is not so clear To take wealth from one class by taxation and to use it for the benefit of other classes may check

production in two ways The increasing burden of taxation may reduce productivity on the one hand (we shall examine this point in detail later)—the free provision of money or goods may check productivity of those who benefit from the State expenditure on the other There is always a danger that the provision of too much State assistance may by removing responsibility, reduce the will of people to work and to produce for themselves It is for this reason that most social expenditure takes the form of the provision of those goods and services which—as in the case of free education—may be expected to raise the level of national efficiency, and may thus be expected to be in the long run reproductive In this case—the case of free education—the greater equality of opportunity it implies may in itself do something to lead to greater equality of distribution

§ 7 *The Cost of Raising Revenue* All taxation must in the first instance reduce the amount of wealth left in the hands of private individuals, and must therefore make the taxpayers poorer than before The real costs of raising the same amount of taxation will, however, vary from case to case To take the same amount of wealth by taxation from individuals with different incomes will normally cause less sacrifice to the richer than the poorer—while the same amount of taxation may affect the wealth production of the country differently as it may absorb wealth that would have been used for different purposes

To take the second of those points If a tax falls on luxury expenditure—if, for instance, it absorbs the

money that would have otherwise been spent on the expensive furs that wealthy ladies wear on the hottest days the reduction of the spending will probably cause some chagrin to the wearers of the furs It will not, however affect their efficiency as members of society, and this loss in satisfaction will represent the full economic loss

If, however to take another extreme case the tax absorbed money that would otherwise be spent on the necessary food of the poorer workers this would, by absorbing wealth used in buying goods necessary for efficiency not only cause an immediate loss in satisfaction to the consumers but—by reducing the efficiency of the workers—would reduce their producing capacity and reduce the wealth produced in the country as a whole Any result of this kind would be likely to be cumulative

If the tax fell on wealth which would otherwise not be consumed immediately but would be used for investment in productive industry, there would be no immediate loss through reduction of consumption but the production of future wealth would be checked In one sense this means that the wealth of the future is spent on meeting immediate expenditure and tends normally to be a spendthrift policy for a country which consumes its potential capital in this way must find its future income reduced

One more point must be taken into account in estimating the effect of taxation upon production When a tax is imposed it is normally used for a number of years People expect the tax and this expectation may affect the amount of their production A very high tax on

large incomes may check the production of such incomes A man may be willing to make additional efforts for an additional £1000 a year—but if the effect of taxation is to reduce his additional net earnings from £1000 to £500 the economic incentive to produce this additional wealth may be removed If the production of one kind of wealth is exceptionally heavily hit by taxation as compared with other kinds its supply may be reduced and other kinds of production may be substituted For instance if capital invested in agriculture is exceptionally heavily taxed, the supply of agricultural capital will be checked and the supply of capital for other production will be increased If all saving is exceptionally heavily taxed the proportion of wealth saved may be reduced and the proportion spent may be increased

The possible effects of specific taxes upon the production of wealth we shall deal with in more detail later Enough has been said here to show that both the loss due directly to the levy of the tax, and the loss due to the expectation of the tax have to be taken into account In practice it is extraordinarily difficult to trace such results, but one point seems clear The greater the burden of taxation relative to the wealth of the community, the greater is likely to be the difficulty of finding new sources of taxation without affecting production adversely, and the greater is likely to be the danger of the burden of taxation reducing the incentives to production From this a general working rule seems to appear that the heavier the burden of taxation the greater is likely to be the real cost of raising further revenue, and the greater will have to be the

gains expected from further expenditure to make it worth while

§ 8 *Extension of Government Spending* There has been considerable discussion as to how large a part of the wealth of a country should be absorbed for purposes of State expenditure The view of the classical economists was broadly that apart from defence and justice, which had long been regarded as the primary duties of the State State intervention and consequently State expenditure should be kept at a minimum This theory was based on the belief that to leave wealth to private individuals would normally lead to its being used in the best interests of the individual and of society so that Government intervention would certainly injure production and would not improve distribution These writers were largely influenced by the prevailing economic conditions of the late eighteenth and early nineteenth centuries, and also by the corruption and inefficiency which characterised Government intervention and Government finance Probably their policy was the best for the period for which they wrote

The last hundred years have seen great changes both in economic conditions and in the efficiency of Government administration, and in England and in America, as in other advanced states there has been a tendency, which has been accelerated during the last twenty years, to extend the activities of government—with consequent increase in expense This change is based on the realisation that wealth in the hands of individuals may be wasted from the point of view of society and that the interest of the individual does not invariably serve to

further in the best way possible, the real interests of the community

There are probably few even of the most extreme individualists who would deny to day that some Government spending will be in the best economic interests of society

Once it is admitted that it is possible by Government spending to increase economic prosperity, it may be argued that the logical conclusion must be that every Government should push its spending until the gain from the increased collective spending is no greater than the gain that would result from leaving the wealth in the hands of private individuals Each individual tends consciously or unconsciously to lay out his income in the way which will give the maximum return He may make mistakes he may act impulsively and stupidly and regret it in the light of experience but no normal person deliberately spends a pound in one way if he knows he can get greater benefit from spending it in another In the same way a Government which represents—or should represent—the collective interests of the community must—it may be argued—attempt to see that the community gets the greatest benefit from its wealth As long as leaving wealth in the hands of private individuals obtains this result no intervention is desirable, but when Government by collective expenditure can turn the wealth to better account this expenditure should be undertaken—that is, expenditure should be pushed to the point when the cost of raising further revenue would be as great as the gain resulting from further expenditure

The great difficulty in the way of carrying a policy of

this kind into practice is that there is no automatic check to show how far the different kinds of spending should be developed We have emphasised the difficulty of tracing the results of increased taxation It is equally difficult to forecast the results of many kinds of Government spending Much of such spending is only expected to show indirect returns over long periods, and it is difficult, even after trial, to prove definitely either failure or success Further if a Government once commits itself to any policy it is often difficult to withdraw and as a public undertaking does not need to make a commercial profit and does not disappear automatically if it fails to do so, schemes may be continued which must by any reasonable standard be judged to have failed Finally, the limitations of the administrative efficiency of governments and the possibility of political corruption have to be taken into account It is easy to see that a rapid extension of Government spending may easily result in the compulsory reduction of individual incomes by taxation for purposes which increase neither the present nor the future economic prosperity of society nor contribute any other benefits at all in proportion to their cost

In practice periods of rapid increases in expenditure are often followed by periods of violent retrenchment Both have their dangers In the first expenditure may be extended unprofitably administrative extravagance may creep in and schemes which should be abandoned may be retained But in the reaction the demand for economy may be equally unintelligent Anything that cuts down unproductive expenditure (such as a disarmament agreement or a more conciliatory foreign

policy) must mean pure economic gain Anything which can check administrative waste without affecting administrative efficiency is also pure gain But hap hazard cuts into productive expenditure may easily become the merest caricature of economy In 1776 the people of Pennsylvania wrote into their constitution that 'the purpose for which any tax is to be raised ought to appear clearly to the legislature to be of more service to the community than the money would be if not collected' This is as sound a principle to day as it was one hundred and fifty years ago And it is equally true that before a tax is rescinded it ought to appear just as clearly that the gain from the reduced taxation will be greater than the loss from the reduced expenditure

CHAPTER II

TAXATION AND EQUITY

§ 1 *The Distribution of the Burden* If the payment of taxation is regarded as a burden that individuals have to bear in the public interest it might seem that the most obvious and fairest way of distributing it would be to call upon each member of society to make an equal money contribution Such a method would, for modern conditions be both impracticable and unjust If in a country as heavily taxed and with such unequal individual wealth as the United Kingdom equal payments were exacted, the real burdens imposed upon individuals would be very far from equal The rich would pay only a small percentage of their incomes while the poor would have practically nothing left Having paid over their incomes in taxation, they would presumably have to be supported by the State The position would be obviously both unjust and ridiculous Where there is no great difference in the economic prosperity of individuals and where taxes are light, the same objections to uniform taxes per head of population do not exist and, as a matter of history such poll taxes have played an important part in the finances of most primitive economic states

Where considerable inequality of wealth exists it has

generally been held that taxation should be distributed among individuals "according to their ability to pay" The problem then resolves itself into finding what constitutes *ability* This has generally been approached from the side of the burden or sacrifice involved in the tax payments, and it is held that people pay according to their ability, and are fairly treated if the payments exacted impose equal burdens This was the dominant idea in the philosophy of taxation in the nineteenth century and many attempts have been made to find a working solution of the problem of distributing taxation in a way that will result in equality of sacrifice

§ 2 *Proportionate Taxation* In the middle of the century the most popular solution seems to have been that taxable ability increased (with certain modifications) in proportion to income, so that taxation proportioned to income would result in equality of sacrifice John Stuart Mill, in his *Principles of Political Economy*, published in 1848 put forward the three following suggestions for an Income Tax —

1 A minimum of income necessary for physical existence should always be free from tax on the ground that to cause people to reduce their expenditure on necessaries causes a sacrifice entirely incommensurable with that caused by reducing other kinds of expenditure

2 Beyond this minimum (which Mill put at between £50 and £100 a year) all income should be taxed proportionately i e if the tax were 10 per cent and the exempted minimum £100 an income less than that would pay nothing and all incomes over £100 would

pay 10 per cent of the amount by which they exceeded that sum

3 Mill would have taxed earned incomes at a rather lower rate than incomes from investments He justified this on the grounds that the recipients of the first class of income have to make provision for the future which is not necessary in the case of permanent incomes He recognised that to make a perfect theoretical adjustment of differences of this kind elaborate allowances would have to be made for differences in family responsibilities, for the difference in taxable ability between a man with £500 unearned and one with £500 earned income is presumably greater when the latter has young children than when he has none Such differences could not be met by a simple difference in the rate of tax on earned and unearned income Mill held that more elaborate schemes of differentiation were administratively impossible, 'but the difficulty of doing perfect justice is no reason against doing as much as we can'

The real weakness of Mill's scheme from the point of view of equal sacrifice is that there is no real evidence to show that even with the modifications he allows proportionate taxation of income really imposes equal burdens on the taxpayers It is probably a closer approximation than the payment of equal money contributions because it recognises the fact that equal sums of money generally mean less to the rich than to the poor But there is no evidence that the payment of a tax of £25 by a man with £500 a year means the same burden to him as a tax of £250 paid by a man with £5000, and even if we were convinced that the burden in

this case was equal it does not logically follow that the payment of £2500 would cause the same sacrifice to a man with £50 000 a year The only reason that Mill gives for believing that proportionate taxation leads to equal sacrifice is that he thinks it does It is simply a matter of opinion

§ 3 *Progressive Taxation* During the years since Mill wrote opinion has changed, and it is now generally held that to arrive at approximately equal burdens taxation must be distributed in such a way that as incomes increase, the amount paid in taxation should increase, not *proportionately*, but *progressively* The idea of progression fits in with our general ideas of fairness It seems fair that the broader shoulders of the rich should bear the heaviest share of the national burden of taxation and there seem rational grounds for assuming that as incomes increase and the surplus beyond necessary expenditure becomes larger and larger, these incomes can pay increasingly heavy rates of tax without encroaching on any necessary expenditure, and without causing any positive hardship to the tax payers Any general agreement of this kind however, carries us very little way in determining exactly how the rates of tax should be distributed between different incomes, or even between different individuals with the same incomes and different responsibilities The same quantity of taxation might be distributed progressively in innumerable different ways, and there is no objective test to tell us which of these results in equal burdens to the taxpayers This is and must remain a matter of opinion

§ 4 *Equity in Practice* Considerations of equity seem to lay down certain guiding principles —

1 Some degree of progression is essential Even Mill s scheme of the exemption of a minimum for necessaries resulted in very slight progression in the rates of tax on total incomes

2 The progression must never be carried to a point at which a man s net income after the payment of tax is actually reduced by an increase of income This amounts to saying that rates of tax should never be more than 100 per cent on any part of income

3 In no circumstances can taxation be equitably based on purely arbitrary principles which can have no connection with taxable capacity—e g special taxes on people with red hair or on people over six feet would always be inequitable

4 Taxes must not fall so heavily upon one class that the standard of living of that class has to be appreciably reduced while other classes still retain a surplus beyond a reasonable standard It should however be added that there is by no means complete agreement as to what constitutes a *reasonable standard* for any class

The above are at most limiting principles and give very little positive guidance for the distribution of taxation How small a way principles of equity take us is illustrated by a case that was discussed before the recent Income Tax Commission In this country the incomes of a man and his wife are for purposes of income tax regarded as one income This is not carried to its logical conclusion, because a larger minimum is exempted from tax in the case of a married couple than of one individual (although this exemption is

not, as one would expect, double the exemption given to a single person) Apart from the exemption (and a very small extra allowance where the wife's income is earned) the joint income is taxed as one income This means, of course that when both the man and woman have incomes the tax paid on these incomes after marriage will be higher than before, because the rates of tax become progressively heavier as incomes increase This has been attacked as an additional and quite inequitable tax upon the married as compared with the unmarried The contention that the only equitable proceeding is to tax the incomes separately both after as well as before marriage, is countered by the objection that to do this would create another injustice The taxable capacity of a man, it is argued, is greater where his wife has an independent income than when she has none and it is unreasonable that if a married couple have a total income of, say, £1000 belonging in equal proportions to both of them, they should pay considerably less in tax than if they had £1000 belonging exclusively to one of them The most obvious solution of this difficulty would seem to be to assess the income jointly in all cases and then to regard them as two equal separate incomes, i e a total income of £1000 would be taxed as though composed of two incomes of £500 whether it belonged exclusively to either party or was contributed by both in any proportions But even this hardly appears perfectly fair It puts the married at a certain advantage as compared with the unmarried, for it would only be where the total income was contributed equally by man and wife that the tax paid after marriage would be as large as the tax paid before For

moderate incomes perhaps this does not seem unreasonable, but where the total income is large it is more doubtful. Can it really be regarded as fair that a man with £30,000 a year on taking a wife without an independent income should find his taxation reduced to less (very considerably less) than half of what he was paying as a bachelor with the same income? Is his ability to pay taxes really reduced in that proportion?

There is, as we have said, no objective test to show how the ability to pay taxes of a married couple differs from that of the unmarried with equal incomes or how the ability of couples with different incomes varies with their incomes. The actual solution which has been adopted in this case is fairly typical. The incomes are jointly assessed (which is the most remunerative solution for the exchequer) while the cases where greatest hardships would arise are met by giving the exemptions we have already referred to. It is impossible to say what exactly constitutes equity but it has been attempted to prevent great real suffering. The case suggests that a more definite principle than the one of equity is needed.

§ 5. *Taxation and Minimum Sacrifice.* J. S. Mill who, as we have said, advocated equality of sacrifice between individuals as the only right aim in distributing the burden of taxation held that it had the further merit that it would necessarily lead to the least sacrifice to the community as a whole. But this is wrong. If it were agreed that it causes equal sacrifice to take £10 from a man with £100 a year and £10,000 from a man with £100,000, then in raising a tax of £10,000 the total sacrifice would be less if it were all taken from the man

with £100 000 than in sums of £10 from a thousand people with incomes of £100

To raise taxation with the loss of least immediate sacrifice to society as a whole, those parts of wealth should be absorbed which give the least satisfaction That is, if the income over £100 000 of people with more than that amount affords less satisfaction than other incomes, then as far as possible all taxation should be concentrated on those incomes, and all other incomes and all other wealth should go untaxed If the highest incomes afford least satisfaction, and most people agree broadly that an additional pound means less to a man the richer he is taxation should be concentrated on them until the net incomes (incomes minus tax) are reduced to the size of the next incomes when these too would become liable to tax

This theory was put forward by Professor Edgworth Theoretically it has the merit of laying down a definite policy but its practical weakness is obvious and, in fact, it has never been advocated by him as a practical policy If taxation absorbed 100 per cent of the highest incomes, then such incomes would tend to disappear As the higher incomes disappeared taxation would fall constantly upon lower ones The system might involve the least sacrifice to society in the first instance, but over a longer period the gradual disappearance of the larger incomes, the reduction in the available supply of capital which this would involve, and the consequent reduction in the wealth producing and taxpaying capacity of the country would show the essential costliness of a system which looked only at immediate results, and ignored the reactions upon future wealth

production The tax might be raised with the minimum loss in the first year but it would be at the expense of future production There seems however, no reason why the idea of minimum sacrifice should be looked at simply from the short period point of view A tax may reduce economic prosperity both by absorbing wealth yielding immediate economic satisfaction and by absorbing wealth which would otherwise contribute to future production If both these factors are considered the logical economic position for the State would seem to be to attempt as far as possible to distribute taxation in the way that will, taking both present and future prosperity into account injure as little as possible the permanent economic interests of the community This involves considering not only the immediate loss in satisfaction to the taxpayer but also the productive value of the wealth taxed It is not a principle that is easy of application' but it is certainly more definite than the idea of equal sacrifice

§ 6 *Equity and Economy* The doctrine of minimum sacrifice as we have interpreted it, would not necessarily clash in practice with the principles of equity which were the only definite results that that idea seemed to give us Certainly all these principles seem justifiable both on grounds of economy as well as grounds of equity The real change introduced by the idea of minimum sacrifice is the definite recognition of the fact that in considering what constitutes equity not only the immediate loss to the consumer but also the productive loss due to the tax must be considered, so that a tax that achieves immediate equality between A and B may

achieve it at too high a price if it means that in future both A and B and possibly C and D will have heavier burdens to bear

This idea has long been accepted in practice The heavy taxation of alcohol in this country cannot be regarded as equitable, in the sense of imposing equal burdens for it falls exceptionally heavily on the poor and it penalises very heavily certain kinds of expenditure quite irrespective of the means of the spenders This taxation is accepted as fair (where similar food taxes would be condemned) because it is believed that much money spent on alcohol is from the point of view of society spent unprofitably The war tax on excess profits was not graded at all according to the individual incomes of the taxpayers (a company making excess profits paid the same percentage of them to the State whether the shareholders were poor or rich), mainly because it was a source of economic wealth that could be tapped without serious economic reactions, at a time when the need of revenue was particularly great Even the great recent developments in progressive taxation seem to have been accepted as much on the grounds that they were the most economical methods of getting the high revenues needed, as that they conformed to any abstract standards of equity Certainly thirty, twenty or even ten years ago such steep gradations of taxation as we have to day would have been condemned in unmeasured terms as robbery of the rich

§ 7 *Progressive Taxation and Economy* Progression has been so generally justified as leading to greater equality of sacrifice that it seems worth emphasising

that both opinions and practice on this point have been largely formed by the economic conditions and fiscal needs of the time. When taxes were low and wealth was fairly equal, poll taxes caused no great anomalies. When taxes absorbed a larger but still moderate proportion of wealth, taxation proportioned to income caused no great hardship, and when a minimum for physical necessaries was exempted did not encroach appreciably upon necessary expenditure. When taxation became increasingly heavy and inequalities of wealth increasingly great, progressive taxation became the only practical method of raising the revenue needed. For where few people would find a tax of 2d. or 3d. in the £ a hardship, a reduction of net incomes by 1s. in the £ might entail economies which would encroach appreciably upon expenditure, cause considerable suffering and probably reduce efficiency—a result which is to be condemned both on grounds of justice and economy. If this is recognised and a lower rate of tax allowed to those near the margin, then the principle of progression is in effect admitted.

In this country graduation of income tax for lower scales of income was admitted as a practical necessity, and generally accepted in the early days of the tax, but although the principle was admitted in this way, graduation of the rate on higher incomes was long opposed as savouring of impiety. Before the war the increased revenue needed constituted one cause leading to the acceptance of a more progressive tax, while during the war the need of getting more revenue compelled many countries to adopt a more progressive system of taxes than they had done before. Apart

altogether from questions of equity, taxes amounting to 5s or 6s in the £ in the £ cannot be imposed on small incomes without reducing the standard of living of large parts of the Community Small incomes have only a limited margin over necessaries and to tax them below (or even to the margin) must nearly always result in disaster As the revenue to be raised increases, more and more incomes have to be taxed at less than the full rate, and the result is that the burdens on the largest incomes to raise the same revenue have to be increased It is the only practicable method of getting the revenue, and public opinion has come to accept it as equitable From the point of view of equality of sacrifice it is difficult to justify any particular rates of progression, but where the total revenue to be raised is high a stronger case for steep progression can be made from the side of economy

§ 8 *Equality and State Expenditure* One last point may be noticed in this connection A too rigid insistence upon the necessity of equality between taxpayers as tax payers as the only just treatment seems irrational in the light of the social policy of most progressive states Most countries are attempting in one way or another to bring about some social and economic readjustments—expenditure on health and education has been developing, and more constructive policies have been adopted for the help of the poor in periods of special necessity When the State recognises in its spending policy that it may be in the public interest that individuals should receive unequal treatment, it seems doctrinaire that in collecting revenue it should attempt to aim at rigid

equality of treatment Seventy years ago Newmarch said that it was no part of the system of taxation to correct the vicissitudes of fortune' But whatever was true in 1852, in 1922 the spending policy of the Government recognises the social necessity of some correction of such vicissitudes and it seems illogical in view of this to lay too much emphasis upon equality in distributing the burden of taxation

CHAPTER III

PRACTICAL PROBLEMS

§ 1 *Administrative Difficulties of Personal Taxes* Whatever theories of taxation may be accepted, their application will always be limited by the practical difficulties of administration However attractive a tax may seem in theory, it is practically useless as an instrument of revenue if the larger part of its yield is swallowed up in the costs of collection However fair a tax may seem on paper, it will be fundamentally unjust in practice if a large part of the people who should pay it can evade it with impunity

For many years the development of any scientific scheme of taxation was heavily handicapped by administrative difficulties Personal taxes, i e taxes levied directly upon the income or property of the individual, were almost impossible because of the difficulties of assessing the income or wealth to be taxed Immovable property was easy to assess—it was visible and fixed—but to assess property held in the form of investments and still more to assess annual income involved difficulties which most countries have only recently partially solved In many cases when attempts have been made to impose taxes upon property and income, these taxes broke down or concentrated only upon certain kinds

of fixed property The history of the American Property Tax shows many instances of this The English Land Tax was originally intended to affect other kinds of property but gradually fell upon land only When the English Income Tax was first imposed by Pitt the enormous evasion led to a revision of the tax so that it was no longer imposed upon total income, but upon income as it was derived from different sources Wherever possible, the tax was deducted from income before it reached the taxpayer This system of stopping at the source simplified the collection and increased the yield of the tax, but it made the development of graduation of tax on total incomes difficult In spite of many objections the system is still maintained in this country and the tax officials generally hold that the relative efficiency of the English system is largely due to its use

§ 2 *Presumptive Taxes and the Development of Personal Taxes* When personal taxes in their complete form were impossible owing to difficulties in assessment or collection, the taxes were levied on objects which were taken as an index of taxpaying ability Pitt's Triple Assessment was a tax based on presumptive signs of wealth and preceded the English income tax In France where no direct tax on income existed until a year or two ago it was attempted to get the effect of such a tax by four presumptive taxes In England the difficulty of getting any coherent or reliable estimate of net income from farmers who did not usually keep accounts, led to their income tax being assessed not upon their incomes, but upon the rental value of the

farms—the presumption being that this served as a rough index of the profits they were likely to be making. In any community where it is impossible for any reason to get fairly reliable statements of income or wealth from any class some method of levying tax on external signs of wealth has to be adopted. At best it can only be expected to give a very rough approximation to actual taxpaying ability.

Even when direct personal taxes were introduced, administrative difficulties prevented any elaborate graduation, or the use of any other method of adjusting taxes to differences in the taxpayers' needs. All through the nineteenth century the great finance ministers laid emphasis on this need for simplicity of taxation. Gladstone, for instance, refused to introduce in the English income tax the difference in the rates charged on earned and unearned incomes suggested by Mill not because he considered it undesirable but because of administrative difficulties. When Sir William Harcourt introduced graduated death duties in 1894 he stated that it was the difficulty of administration which prevented the application of the same principle to the income tax.

Any increase in the complexity of a tax increases administrative difficulties in two ways:—

1. It increases the cost of collection. "We may take it as a maxim," says Sir Josiah Stamp, "that the nearer any tax is to conforming with a principle, the more difficult it is to collect."

2. Every increase in complexity tends to increase the possibility of evasion. Where no exemptions are admitted it is, of course, other things being equal, more

difficult to get through fraudulent claims for exemption than where some claims are allowed Where different rates are charged it is easier to get assessed at too low a rate than where only one flat rate is imposed Where considerable evasions occur a tax must be essentially unjust, for the righteous suffer while the more dishonest go free and the yield of the tax is reduced

The result of these difficulties has been that, especially in countries where the financial administration has been inefficient or corrupt, or where the taxpayers have been economically undeveloped, or have resented detailed statements of their means, the development of elaborate personal taxes graduated according to means has been difficult Even to day no administration is yet so efficient and no people so conscientious about their payments, as not to make any increase in complexity a very real disadvantage in proposed tax changes

In spite of the administrative difficulties, the last thirty years have seen an enormous development in personal taxes Where previously such taxes did not exist or existed only in the simplest form, elaborately graduated income or inheritance taxes have been developed and both the absolute amount of revenue and the proportion of total revenue raised by these methods have increased Prussia reorganised her income tax in 1873 England introduced graduation into her death duties in 1894, and in 1907 began the great reforms and developments of income tax which continued up till 1920 The United States adopted a federal income tax (which had previously only been used as a war measure, and had been defeated as a permanent tax on constitutional grounds) in 1913,

which was developed in 1917–18 and was an immensely important source of revenue during the war. Even France, where direct taxation was long bitterly opposed, adopted an income tax recently. These developments have made possible a much closer graduation of taxation to the means of the taxpayers. The changes have become practicable only through great administrative changes and would have been considered impossible quite a few years ago.

§ 3. *Productive Indirect Taxes.* Before the great development of direct taxes all countries depended for a large part of their revenue upon taxes imposed on commodities. Such taxes are normally collected from the manufacturer or importer of the taxed goods but it is intended that they shall ultimately be shifted to the consumers in the form of an addition to price. Indirect taxes of this kind are still an important source of revenue in all countries, although with the recent developments of direct taxes the proportion of total revenue raised from them has tended to decrease.

The number of taxes on commodities which are capable both of cheap collection and of yielding a large tax revenue is limited. Such taxes are expensive to collect unless they can be imposed or checked at certain centralised places. The popularity of customs duties from the revenue point of view is partly explained because (except in the case of articles of very small bulk which can be easily smuggled) it is possible to make a fairly close inspection of taxed articles at ports or international railway centres, and the cost of collection is cheapened. Where taxes are imposed on commodities

produced and consumed in the taxing country their production has to be watched, and except when the production is centralised the collection becomes costly and difficult Where taxes can be collected by stamps—as in the case of the entertainments tax—a widely diffused tax may be more easily collected

If taxes are imposed on commodities which are not consumed on a large scale the yield of the tax will not be great, and the cost of production is likely to absorb a large proportion of it If the taxed commodity is one where a slight rise in price means a falling off in consumption the tax is likely to be thoroughly uneconomical The rise in price due to the tax will kill the demand and dry up the source of the tax The consumer suffers because he has to find an alternative commodity the producer suffers from the check to his sales and the national coffer does not gain Any attempt to increase the productivity of the tax by increasing its rate defeats its own ends We shall deal with this point later but the net yield of an indirect tax is likely to be great only where the three following conditions are found —

1 The tax must be capable of fairly easy collection
2 The commodity taxed must be largely consumed
3 The demand for the commodity must be so stable that a fairly heavy rate of tax can be imposed without destroying consumption

§ 4 *The Taxation of Necessaries* The commodities which fulfil the last two conditions are chiefly necessaries, for these are largely consumed and people are not likely to economise on them to any very great extent if their

prices rise moderately A small rise in the price of bread or sugar or tea is not likely to check demand, and probably for all necessaries a fairly inelastic demand exists unless there is an obvious substitute easily available Taxes on conventional necessaries have some of the same advantages Tobacco and alcohol are largely consumed by all classes while the demand for them (although they are not strictly necessaries) is inelastic enough to stand very considerable taxation Technically all such commodities would seem to be suitable objects for taxation But the great objection to all taxes on articles of staple consumption is that they are likely to fall more heavily upon the poor than on the rich Such commodities absorb a larger part of the expenditure of the poor than of the rich, so that a tax on them is a heavier proportionate tax on the incomes of the poor What is more when the tax is imposed at a flat or specific rate at so much per pound or per piece, this will push up the price of the cheaper grades which are presumably consumed by the poor, more than the price of the more expensive articles which are presumably consumed by the rich A tax of 6d a lb on tea worth from 1s 6d to 4s a lb would add 33⅓ per cent to the price of the cheaper and only 12½ per cent to the price of the better tea Taxes of this kind may be said to have a *double differentiation* against the poor

Attempts to meet the first of these points by taxing luxuries which figure mainly in the budgets of the rich, generally show little yield to the exchequer, for the demand for most luxuries is relatively small and elastic Attempts to meet the second point by charging not *specific* but *ad valorem* rates (i e rates varying with the

value of the taxed commodities) involve administrative difficulties for the necessary valuations cause practical difficulties and make it harder to safeguard a system of *ad valorem* rates against fraud and evasion Some countries, as Canada and the United States have *ad valorem* customs duties, but most have not attempted them on a considerable scale, and Germany after trial abandoned them

In practice, taxes on foodstuffs and such conventional necessaries as alcohol and tobacco seem to have proved the most remunerative. In this country the liquor and tobacco taxes with a substantial contribution from tea have been the main sources of revenue from indirect taxation during the last period In pre war Germany the import duties on grain yielded far more than those on finished and half finished goods in spite of her elaborate tariff policy There can be no doubt that taxes of this kind may be made to yield very large revenues but the great argument against them is that as they cannot be adjusted to differences in means they throw an inequitable burden on the poor The case against taxes on conventional necessaries on these grounds is not so strong as the case against the taxation of necessaries

§ 5 *The Case for Indirect Taxes* In spite of the development of direct taxes indirect taxes are still used in all tax systems Their retention is generally defended on the grounds that they are a means of reaching the poorer classes on whom it is difficult to levy direct taxes In a democratic country it is argued it is essential for political security that all classes should

be made to contribute to taxation As a political argument this does not really concern us It may, however, be suggested that the method by which indirect taxes are paid through enhanced prices is not calculated to bring home to the taxpayer (more especially in the case of old taxes) the fact that he is contributing to revenue It is possible to make a fairly strong economic case for the use of some indirect taxes They serve as a useful complement to direct taxes—a point we will deal with further in the next chapter There can be no doubt that some such taxes can be levied conveniently are extremely productive and are probably paid with less conscious ill feeling than direct taxes The taxes on tobacco and alcohol in this country are pushed at present to extreme limits but fairly high rates of tax can be levied without real hardship especially when the country is accustomed to them and the initial friction of their imposition has worn off

The most important argument for maintaining indirect taxes is undoubtedly that it is always important to have a fairly broad basis for revenue Too heavy taxation at any one point is likely to have disastrous results It is an incentive to fraud to all kinds of indirect evasion which cannot be regarded as fraudulent (as at the present time the evasion of the highest rates of income tax by settling property on children), and it is likely ultimately to cut off the source of the tax During the Napoleonic wars we had indirect taxes pushed to a point where smuggling and every kind of evasion was encouraged At the present time the high rates of income tax seem to be getting near the same point and we have the periodic appearance of apparently

highly respectable citizens in the police courts charged with extensive frauds The annual loss to income tax through evasion is considerable It is interesting to note that in the opinion of an ex Commissioner of Income Tax, public morality on the subject of tax paying was improving before the war but the war increases were too great for this new found morality and since then there has been a considerable falling off It is, perhaps this fact which accounted for the curious phenomenon of the elderly man who during the war had not harsh enough things to say about younger men who showed any hesitation in risking their life (not to mention their entire future prospects) in the army and yet in the next breath would be heard boasting of the ways in which he personally had evaded his taxes!

There seems no doubt that unless there is a measure of consent on the part of the taxpayers the collection of any tax is difficult The excess profits duty probably only worked as well as it did because of a certain measure of consent on the part of those who paid it The land values duty of 1909 was largely wrecked by the bitter opposition which met it The evidence of the officials before the Income Tax Commission laid stress upon the point that modifications which might be considered inequitable would be likely to increase the difficulties of collection Wherever a tax becomes so high that its rates become extremely burdensome the difficulty of collection is likely to be enhanced by the attitude of the taxpayers, while the yield of the tax is likely to be reduced by the reaction of the tax on production The use of some indirect taxation is valuable because it enables increased revenue to be raised at

different points instead of by exclusive concentration on the great direct taxes

§ 6 *The Limitations of Indirect Taxes* Although indirect taxes may be used to raise some part of revenue and to relieve the direct taxes, their utility in this direction is generally limited, and it is important not to exaggerate their possibilities The number of commodities yielding large revenues economically is small and these consist mainly of conventional necessaries and necessaries If these taxes are extended too far, the result is a crushing burden on the poor If, on the other hand, the taxes are extended to many other kinds of commodities, this may lead to the inclusion of unproductive taxes England after the French wars, when her need of greater revenue caused an indiscriminate extension of indirect taxation afforded a good illustration of its evils There was universal and crippling interference with industry, and in many cases the revenue yield was negligible The net yield of the tax on saltpetre was said to be 2d ! For years after the Peace the main financial business of the country was the abolition, reduction and simplification of these duties It is said that under Peel's administration 1035 customs duties were reduced and 605 totally abolished, without any appreciable decrease in revenue ! The difficulty of getting any greatly increased revenues from indirect taxes alone has been illustrated more recently The finances of Imperial Germany were seriously handicapped before the war by the impossibility of using direct taxes France's present financial problems are partly accounted for by the fact that she has only recently begun to develop

her direct taxes and that indirect taxes were entirely inadequate to meet her war needs It may in modern conditions be possible to rely too greatly on one or two great taxes and thus to impose too heavy burdens at certain points, but it is certainly entirely impossible to raise the great modern revenues without relying on direct taxes for the bulk of them

§ 7 *A Practical Advantage of Income Tax* One last technical advantage of the income tax may be noticed in this connection Where new indirect taxes are needed new administrative charges are necessarily incurred and, further their development may take time Where the necessary administrative machinery is once in existence, the yield of the income tax can be increased rapidly, and without corresponding increases in administrative charges, by a simple increase in rates This elasticity is obviously a great advantage where sudden increases in revenue are needed The death duties have apparently similar advantages but they are not an equally suitable means of raising temporarily increased taxation A short period increase in the death duties means that all estates which chance to change hands through death in a certain period are subject to exceptional taxation while other estates escape The rates of death duty to be fair cannot be subjected to rapid readjustments

CHAPTER IV

TAXATION AND PRODUCTION

PART I THE STANDARD TAXES

§ 1 *Different Uses of Income* We showed in the first chapter that individuals may use their incomes in ways which affect differently the future productivity of the country Income spent on necessary consumption is from the point of view of future production, money invested in maintaining the country's human capital, and any deterioration in this is likely to reduce production Income which is not consumed but invested for a future return is expected to add to future output Income spent on purely luxury expenditure does not strictly speaking increase the producing capacity of either human or material capital, and to check it will not react directly upon future productivity

All taxes must reduce the net incomes of individuals in the first instance This will further reduce future incomes if the taxation reduces productive capacity by absorbing wealth that would otherwise be used for productive purposes, reduces the economic incentives to production or leads individuals to use their remaining resources in less productive ways It would seem from the point of view of national production (which is not the only point of view that ought to be considered in

practice) that the individual use of income that the country can best afford to do without is the unproductive expenditure And it follows that if taxation discriminates against any individual uses of wealth, the loss to production will be less when the unproductive rather than the productive uses are discouraged

§ 2 *Expenditure Taxes* In practice it is not easy to find revenue yielding taxes which will fall chiefly on the unproductive uses of wealth The most usual method has been to levy special taxation on the luxury commodities

If, for instance, expenditure on tobacco is regarded as unproductive a tax on tobacco may be expected to absorb part of the wealth that would otherwise be spent on it If the tax is so high that it has the effect of doubling the price to the consumer everyone who now spends 6d on tobacco will have to pay through higher price an additional 6d to the State Those who do not buy do not pay As people do not presumably enjoy paying taxes there is an incentive to them to check their consumption If at the taxed price people buy only half as much (paying, of course, the same amount in price and tax) it may be assumed that half the money previously spent on tobacco now goes to the State

In practice people would almost certainly spend more on this commodity than they did before, for many of them would regard it as a necessary In this case money which would otherwise have been spent in other ways (which may or may not have been productive) would now be spent on tobacco Unless people were willing

to buy as much at the higher price (and there would almost certainly be some people who could not afford this) it may be claimed that some of the money that would otherwise have gone on tobacco would now be absorbed by the tax

If the tax were so high that consumption was greatly reduced this would check its yield and would condemn it from the point of view of the Chancellor of the Exchequer, whose first necessity is to get revenue When individual forms of expenditure are taxed there is always this danger Expenditure may simply be diverted from one commodity to another (people might for instance, buy less tobacco and more beer if only the former were taxed or if it were taxed much more heavily) a result which would presumably cause some loss in satisfaction to the consumers, as the readjustment would only be made as a result of the tax and which, as we have already said, would offer no corresponding gain to the revenue

The last danger might be avoided if taxation were levied not upon isolated commodities but upon all kinds of expenditure which can be considered unproductive Something approximating to this was attempted in the luxury taxes which were proposed in many countries and imposed in some during the war During this period the needs of the revenue the shortage of necessaries and the extreme importance of encouraging saving made the case for taxing unproductive expenditure exceptionally strong, and taxation was proposed which was intended to hit as far as possible all kinds of luxury expenditure

Experience confirmed the belief that taxation of this

kind would present difficulties both of definition and of administration The practical definition of luxury expenditure is extraordinarily difficult Expenditure on some commodities (e g precious stones) may always be regarded as luxurious, other commodities may rank as luxuries in one case and necessaries in another according to their cost A coat costing £5 may be a necessary one costing £25 a luxury On the other hand extravagance consists sometimes not in the *kind* of goods bought but in their number Two pairs of shoes in a year may be necessary, ten simply extravagant There would be little gain if taxation was enforced on expensive articles only, and its result was to encourage people to buy larger numbers of cheaper ones

The practical difficulties of drawing up a scheme of taxation which would take these facts into account were great The collection of the complicated and widely distributed tax was expected to prove costly and difficult Actually the English scheme for luxury taxation was never put into force, and the French scheme, after a very short trial was changed into a general tax on the turnover of all businesses (which had also been adopted as a war measure in Germany), which it was hoped would prove more remunerative to the Treasury This tax really amounts to a general tax on all expenditure necessary and unnecessary, and as such must tend to raise the cost of living and to hit the poor (who have a smaller margin beyond necessary expenditure) much more heavily than the rich

The failure of luxury taxation during the war showed that there is little to be hoped from general taxation of this kind as a source of revenue in the immediate future

On the other hand wherever taxes can be successfully imposed on individual forms of unproductive expenditure there is a case in their favour—from the productive standpoint—in the fact that they hit the less productive uses of wealth. Such taxes are not without disadvantages. They may be partly met by wealth drawn from other sources and thus indirectly react on productivity. By discriminating against one kind of expenditure they may check its development and may thus alter the natural development of production. All this is true. But the real point is that taxes almost inevitably discriminate against some use of wealth by individuals, and it is arguable that the State if it wishes to maintain production should deliberately discourage its less rather than its more productive uses.

As a matter of practice there seems no doubt that given our present enormous expenditure the bulk of our revenue will have to come from direct taxes because of the practical difficulty of finding sufficient indirect taxes yielding considerable revenue without encroaching on necessaries. But where taxable unproductive expenditure can be found there is a good deal to be said for taxing it. In practice taxes on commodities have tended to fall on necessary rather than unnecessary articles of consumption.

§ 3. *The Effect of an Income Tax on Spending and Saving.* The name income tax suggests a tax imposed upon income as income irrespective of its use. The view that it is not a discriminating tax has been generally accepted, and taxes on income have been defended on the grounds that as they leave individuals free to select

their own economies, they do not give any unnatural twist to production Unless special reasons can be shown for discouraging certain kinds of production, this is likely to lead to the least check to production as a whole relative to the tax yield The general argument is in the main sound It is, however not true that an income tax on the English model does not show some discrimination between different uses of wealth

Practically every income tax makes some effort to exempt expenditure on necessaries by leaving a minimum of income free from tax There is little agreement as to what the exempted minimum should be The English minimum of £150 for the unmarried and £225 for the married is low both absolutely and compared with the American minimum of $1000 for the unmarried and $2000 for the married At most the English exemption can claim to cover physical necessaries, and in the lowest ranges of taxable incomes at least the tax must often encroach upon expenditure that is essentially necessary for the fullest development of industrial or professional efficiency The low minimum perhaps exaggerates the incidence of the tax on small incomes for exemptions and abatements relieve a large part of them from tax In 1918–9, for instance, of all the incomes between £130 and £160 that came under the eyes of the Income Tax authorities less than 4 per cent paid tax Even so the minimum is not a generous one

Apart from these exemptions and abatements income taxes do not apparently distinguish between different uses of incomes You pay the tax whether you put your income in war loan or railway stock or spend it on

diamonds or on a trip to Monte Carlo But looking at the matter from a longer point of view, if you spend you got your diamonds or your amusements at Monte Carlo and you have finished with the tax, if you invest so that your investment becomes a source of new income this new income becomes liable to tax Further as this income will be derived from an investment it may be taxed at a rather higher rate than earned income Finally, as the income from the new investment will increase the total income of the taxpayer, it may happen under a progressive tax that the increase in taxation is proportionately much greater than the increase in income

Many economists from the time of John Stuart Mill have held that new savings should be exempted from income tax, that as the savings of one year constitute the new capital of the next they should be regarded as capital and exempted from taxation as income This argument derives its force from the fact that capital is essential for the development of industry, and that anything checking the supply of capital must react upon future production Unless some such exemption is given, an income tax must tend to encourage spending at the expense of saving and although this is probably practically unimportant when the rates of tax remain low it becomes increasingly important as the rates increase

The general exemption of savings has so far not entered into the sphere of practical politics and the only important exemption in this country is the allowance for certain forms of life insurance There would be at least two arguments against a general exemption, apart from the important practical difficulty that it

would greatly increase the complexity of the tax for administrative purposes

1 The individuals who do the bulk of saving belong to the wealthier classes They save, not from any special virtue, but because they have the means To exempt their savings from taxation would seem to give them an additional and rather unfair advantage in accumulating wealth It is possible to over emphasise this The exemption would only be given in the actual year of saving and as soon as the investment yielded income this income would be liable to tax unless it also were saved The exemption would be simply a method of not encouraging people who have the power either to save or spend to exercise that power in the way which is on the whole least likely to increase production As soon as the savers personally began to reap the benefit of their increased incomes by spending them they would be liable to tax

2 The result of the differentiation against saving has only become practically important since the rates of tax became extraordinarily heavy that is since the needs of revenue became urgent The practical problem in these circumstances is if savings are exempted, to find other sources of revenue The real difficulty is not to shew the defects of an existing tax, but to find alternative taxes with less bad effects on production The possibility of income tax discriminating against saving seems an additional reason for using where possible taxes on unproductive expenditure in addition to direct taxes

§ 4 *Income Tax and the Differentiation between Earned and Unearned Incomes* In most income tax systems

earned incomes are in one way or another charged at slightly lower rates than incomes from investments. This may emphasise the discouragement to saving. The lower rate on earned income is, however, a concession to the fact that people with earned incomes have to make a provision for the future by saving, which is not necessary in the case of a permanent income. To some extent the lower rate may be said to make saving possible. The distinction seems a fair one, especially where the earned incomes are small. In England the distinction does not now consist in a difference in the actual rates charged, but in the fact that on earned incomes an additional 10 per cent is exempted from taxation with a maximum exemption of £200. In some European countries three rates of tax are charged: one on earned, one on unearned and one on mixed incomes. Italy has a fourth rate which is imposed on the salaries of Government officials. It is lower than the ordinary rate on earned incomes and is apparently a recognition of the fact that as the Government pays the salaries of those officials it knows what their earned incomes are, and consequently they do not stand on a fair competitive footing with other taxpayers when it comes to making their income tax returns!

§ 5 *Income Tax and the Incentives to Production.* Apart from any question of discrimination between different uses of wealth an income tax may react upon production by affecting both the willingness and the capacity of the taxpayers to contribute to future production. In considering this question it is worth emphasising that the results are only likely to be important where the

rates of tax are high The effects of income tax upon production have gained an entirely new importance during the last ten years which have seen the most extraordinary increases both in the total amount of revenue raised by the tax and in the rates imposed

In 1913 income tax yielded (in round figures) £14 m , in 1918 £258 m in 1921–22 £410 m The highest rate that the English income tax touched before 1914 was 1s 4d during the Crimean War By 1874 the rate had fallen to 3d , and at the general election of that year Mr Gladstone promised the total repeal of the tax if he was returned to power He was defeated and the tax was retained but the new Chancellor reduced the rate to 2d From that date until 1901 the rate never exceeded 8d The Boer War sent it up, and it remained on a higher level during the early years of the twentieth century, but in 1913 in spite of Mr Lloyd George s radical finance the highest rate charged on any part of income was only 1s 8d (1s 2d income and 6d super tax) paid by incomes over £5000 on the amounts by which they exceeded £3000 Even this was held to threaten catastrophe ! In 1921–2 the standard rate of income tax had risen to 6s and the highest rate of super tax to the same amount so that incomes over £30 000 paid 12s in the £ to the Income Tax authorities on any income beyond that amount In 1922 the standard rate was reduced to 5s

In 1921 these taxes meant that an increase in income from £2000 to £2500 meant a net increase of £302 10s to the taxpayer an increase from £15 000 to £20 000 a net increase of £2250, an increase from £30 000 to £35,000 a net increase of only £2000

In considering the effect upon the incentives to production three possible cases may result

1 People s willingness to increase their incomes may not be affected at all They may be just as ready to work and to save for the smaller as the larger increase This implies that people are not influenced at all by the amount of the monetary award they will receive Certainly money is not the only motive probably in many cases it is not the most important, and where the rates of tax are low the influence would probably be negligible Where however the rates of tax absorb anything from 25 to 60 per cent of an increase of income it is more difficult to believe that a large number of individuals will be entirely unaffected To some extent this conclusion is qualified by the fact that a considerable amount of saving is undertaken not by individuals but by joint stock companies who reserve sums out of profits for future needs Directors of companies are not likely to be dominated by quite the same motives as private individuals in determining the amounts to be saved They will be more concerned with the needs of the business and the possibilities of profitable expansion and as the funds with which they are dealing are not presumably all their own they will be less concerned with the possible alternative attractions of greater personal extravagance! The willingness of companies to contribute to future production is probably less affected by taxation than that of private individuals

2 People may be induced by taxation to work harder and save more A tax may make it difficult for people to maintain the standard of life to which they are accustomed unless they can increase their incomes

In the same way when people are saving for old age or to make provision for a wife or children a tax may make it necessary to save rather more before a net income which guarantees them reasonable comfort can be attained It is possible that an income tax may in this way induce some people to work harder and to earn more than before But the people who can only maintain their standard of life by harder work, and who are saving as a provision for the future, are likely to belong to the less wealthy classes whose contribution to saving is likely to constitute only a small part of the whole Further if the tax is maintained for a period of years the standard of life may be modified to meet the new conditions and this is made easier by the fact that people of the same class are approximately affected in the same way Finally, even if people were willing to increase their incomes and their contributions to saving it is by no means invariably possible for the ordinary individuals to do so In a period where over 25 per cent of the working population have found themselves compulsorily without work it is idle to pretend that it is invariably open to an individual to increase his income however much he may personally wish to do so

3 The effect of the tax may be to make people less willing to work and to save This result would appear to be more probable where the rates are high, and is thus more important in a progressive tax for the larger than the smaller incomes As the larger incomes are the main sources of new saving the reaction upon the supply of new capital is likely to be particularly great and is emphasised by the fact that an income tax, as we have already said discriminates to some extent in favour

of spending Further as the heaviest taxation falls on the highest incomes the recipients of which are most likely to control industry there is some force in the argument that the heavy taxation of such incomes will have more effect in checking production than taxation of smaller incomes and may enforce compulsory idleness upon other taxpayers who would be willing to continue production

Where the tax rises steeply in steps the discouragement to a further increase is likely to be particularly great for certain ranges of income For instance, before the recent reforms of the English tax an unearned income of £1500 paid tax at 4s 6d At this point the rate rose from 4s 6d to 5s 3d so that an income of £1501 was liable to tax at the rate of 5s 3d If a special provision had not been made the absurdity would have arisen that the net income of a taxpayer with a normal income of £1500 was £1162 10s while that of a taxpayer with £1501 would have been just less than £1107 Or, in other words the possession of £1 more income would reduce spending capacity by about £55 10s A special legislative provision ensured that his position should not actually be made *worse* by the possession of additional income, but it was not until the income increased from £1500 to over £1576 that the spending power of the taxpayer was *increased* The result was that from £1500–£1576 100 per cent of the increase in income was absorbed by the tax

Where 100 per cent of income is absorbed by tax, probably no one would dispute that this would check the development of incomes of that amount How near to this the rates can approach without having a similar

result it is difficult to say Any definite conclusion as to the effects of taxation on the incentives to production seems impossible The motives of individuals differ, and the case is complicated by the fact that a considerable part of the supply of capital is contributed by companies whose motives are not likely to be the same as those of individuals Where taxation is high it seems most probable that high rates will prove a general discouragement to industry—but at present the question is indeterminate

§ 6 *Income Tax and the Capacity to Produce* Whatever the effect of a high income tax in reducing people's willingness there can be no question that high rates must reduce their capacity to contribute to future production A high rate on the poor would cut into their capacity to produce by reducing expenditure necessary for efficiency A high rate on high incomes must almost certainly reduce their capacity to contribute to saving Where the rate rises to 25 per cent or more of total income it is probably impossible to meet the tax entirely out of economies in unnecessary personal expenditure Even if it were possible, it is improbable that people would be willing to reduce their expenditure very far below their customary standard without reducing the amount of their saving As the largest incomes normally contribute the largest proportion to saving having the largest surplus to save the fact that the heaviest rates fall on them is likely to lead to very considerable reductions in saving In this case corporations as well as individuals are affected The capacity of corporations to save and to expand is reduced when

their net profits are reduced by heavy taxation The recent Report on Incomes in the United States notes that by 1917 'War Taxes had begun to eat into profits a process that continued in 1918 and 19, until in those years the undistributed income of corporations was little more than half that of the exceptionally good year 1916

§ 7 *Income Tax and Investment Abroad* The question how far the rate of return that can be got from investment affects this accumulation of saving is one that has never had a satisfactory answer but experience has shown that if in one country any factor reduces the rates earned by capital as compared with capital abroad this will have the effect of checking foreign investments and is likely further to encourage home investors to invest abroad It is often argued that a high income tax by reducing the net return from investments may check investment in the taxing country in both these ways

Professor Pigou has pointed out that in an old country like England where there is normally little foreign investment the first result will be unimportant while the existing taxation cannot afford a stimulus to investment abroad as all interest from foreign investment payable to residents in this country is liable to tax If the capitalist transferred both himself and his capital abroad he would evade the tax But he cannot live here on the interest of foreign investments without being liable to tax As the willingness of the wealthy to live permanently abroad is not likely to be particularly great the influence of heavy taxes in this direction is not important

In point of fact it is probable that heavy taxation will check rather than increase the free international investment of capital for income from such investment may be subject to "double taxation" both in the country of origin and the country of residence Some international agreement as to the treatment of such income is becoming increasingly important with the general development of the use of income taxes Other things being equal if double taxation checks free investment this will also reduce prosperity, because it will prevent capital finding the most profitable uses

§ 8 *Death Duties* The second great method of direct taxation which has been increasingly used during the last thirty years is taxation of property passing at death As examples of this kind of tax we have the English Death Duties (including Estate Legacy and Succession Duties) and the American Inheritance Taxes

Taxes of this kind may be graduated on any of three principles They may vary with the size of the estate left, with the degree of relationship of those who inherit the property to the testator or with the amount inherited by each individual heir The first of these falls most heavily on large accumulations of wealth the second on inheritance by distant heirs while the third discriminates against the leaving of accumulated wealth in huge sums to one or two individuals

In the English system the Estate Duty (which is graduated from 1–40 per cent) varies with the value of the estate left The Legacy and Succession Duties (which are graduated from 1–10 per cent) vary with the degree of consanguinity In the American Federal

Inheritance Tax the graduation is on the first principle only. In many of the American State taxes and in the French tax graduation is, in part at least, based upon the third principle.

The third kind of graduation differentiates against the passing of large accumulations of wealth to one or two heirs, and is likely where the rates are heavy to discriminate in favour of the more equal distribution of property. The tax is graduated according to the inheritance of the individual, not according to the total amount of the estate left. In many ways this seems the fairer and more reasonable basis of taxation, for it would seem that the taxable capacity is greater where one individual inherits £100,000 than where the same sum is distributed in equal shares between ten or a dozen individuals. It is interesting historically that the great reform of the English Death Duties which was carried out in 1894 by Sir William Harcourt would, except for a political crisis, have been carried out by Lord Randolph Churchill, and it was his intention to make graduation on the third principle the leading feature of his reforms. There can be little doubt that it would have tended to some extent to limit the accumulation of property in a few hands, and that on the whole it might have led to a better distribution without any worse effects upon production than the existing tax. Among the arguments that weighed with Sir William Harcourt were probably that the tax graduated according to the size of the estates left was likely to be more productive to the exchequer (it was impossible to reduce the amount of tax paid by distributing the estate among a larger number of heirs), and was probably

administratively the easiest to make water tight The graduation of the Legacy and Succession Duties on the principle of consanguinity amounts to imposing an additional tax, where the heirs may be reasonably regarded as having no natural claims on the testator

The relative merits of death duties and income tax have been much discussed It is argued that death duties that are payable in a lump sum at long intervals are more likely to be paid out of capital than an income tax which is paid regularly annually It is probable that there may be some force in this argument where the rates of income tax are low and can be met out of minor economies but its point seems smaller where the rates of income tax are high It is improbable that in those circumstances, either high income tax or high death duties will be paid entirely out of wealth that would otherwise have been spent on consumption goods They are both likely to come to some extent out of potential capital—in the case of income tax by reduction of saving in the case of estate duties more probably by realising part of the estate to meet the tax This means presumably that the buyer of the realised estate will use wealth that he had free for investment in purchasing old capital rather than in making a new investment so that both taxes may be said to reduce the new capital of the community When death duties are provided for by annual insurance the effect is probably almost exactly similar to an annual tax on income

How far death duties affect the will to accumulate wealth is as in the case of the income tax, a difficult question Both taxes, of course differentiate in one

sense against large accumulations, because the larger the wealth or income the larger is the tax paid In some ways the death duties may prove less of a deterrent They are a deferred tax, and most people visualise the distant less clearly than the immediate future From the point of view of the individual the time at which they will fall due is indeterminate, and is thus less likely to be anticipated than if they fell due at any specific date Finally, they are imposed at a time which may reasonably be expected to affect the individual less vitally than taxes imposed during his lifetime Death duties leave him his wealth during his life and they do not affect the prestige of leaving large sums at death, both of which may be adversely affected by heavy rates of income tax On the whole, death duties may claim certain advantages in these respects as compared with income tax

Part II The Taxation of Surplus

§ 9 *Taxes on Unimproved Land Values* The possibility of heavy taxation reducing the economic incentive to production has been given increasing importance with the higher rates of tax Neither death duties nor income tax are free from this danger If, however, it were possible to isolate certain parts of wealth, which it could be shown were not the reward of any useful economic service, and which therefore were not necessary to maintain the supply of such service, these could be taxed without affecting production To take a concrete case The value of unimproved land does not depend upon any work or capital put into it by the owner The owner of a piece of land near a growing industrial town

has a valuable possession simply because the growth of the town (for which presumably he was not responsible) has given his land value as an eligible building site' If the town had not grown up, the land would still be there, but its value would be very appreciably less Now if a special tax were put upon buildings the result would be that people would be less willing to build, because the net value of these buildings would be reduced by the amount of the tax—but if a tax were put upon that part of the value of land which is not due to the capital or work of individuals but to the natural advantages of the land, a tax would not affect the supply of it The land is there and although the tax would reduce the return the owners would get from it it would not reduce the supply of land Taxes on the public value of land have played an important part in the finances of New Zealand and the Australasian Colonies In this country the only attempt to use a tax of this type was the small undeveloped land duty introduced in 1909 and abandoned in 1920 There are two objections to a tax of this kind It is not always easy in practice to distinguish between that part of the value of land which is and that which is not due to improvements' and taxes which fall on the former would be likely to check the development of land The second objection is more fundamental Land differs from other kinds of capital in some ways, but in common with other capital it is bought and sold People invest in it as they would in other things for the return they will be likely to get The price they pay will depend upon the return they expect, whether the return is due to natural or to other advantages To put a special tax upon land is

simply to put a special tax upon one kind of investment and seems an inequitable differentiation against one class of investors

§ 10 *Taxes on Increment Values* This second objection may be met where it can be shown that the wealth taxed is due to special good fortune A man who has been specially lucky is not unfairly treated if he is called upon to pay a special tax, and as his increase in wealth is due to luck and not to foresight, the tax will not discourage production An attempt to reach this kind of wealth was made in the taxing, not of all land values, but of increases in the value of land which had taken place over a term of years If a man buys land—it can be argued—and at the end of ten years finds a growing industrial town has spread in the direction of his holding so that he can sell for building at a greatly increased price, this increase may be regarded as due to special good luck and may fairly pay a special tax As a matter of fact the increase in value may not be purely a matter of luck The buyer may have foreseen the possible development into a building site and may therefore have paid a price above the value of the land in its existing uses because of the chance of its development Part of the increase in price that he gets then is not a windfall but accumulated compound interest on his old investment The German schemes for the taxation of land values made some allowance for this point The English scheme introduced in 1909 was to absorb "20 per cent of the increases beyond 10 per cent in the value of land, accruing after April 30th 1909, and was payable on each occasion on which the property changed

hands either by sale or death' This tax did not make any allowance for the compound interest element but practical hardship was probably reduced in two ways Income tax had not been paid during the years of accumulation so that to some extent the tax might be regarded as deferred income tax while the exemption of 10 per cent of the increase in value gave an allowance which probably met the hardest cases The tax was perhaps not perfectly equitable (few taxes are!) but it had the merit of not discouraging production

The tax had an extraordinary history It was introduced with exaggerated hopes and exaggerated fears It precipitated the struggle on the question of financial legislation between the Commons and the Lords After it was finally sanctioned the first necessary step was a complete valuation of land—for a standard valuation was essential for measuring increases in value

The yield of the tax in the first years was small as was of course to be expected and seemed disproportionately small when compared with the costs of the land valuation After 1914 the position was complicated by the rise in prices which made a comparison with pre war values an imperfect measure of real changes in value No effort was made to deal with these difficulties and in 1920 the tax was abandoned The first attempt to tax surplus in this country may be said to have failed The tax has undoubtedly some great theoretical advantages and on the whole seems hardly to have had a fair trial

§ 11 *Excess Profits Tax* The increases in land values are not the only cases where individuals find themselves

in receipt of an unearned increment Businesses especially businesses with monopolistic power may show profits far above those necessary to attract the capital and enterprise to maintain production Any lucky investment may show a considerable element of surplus to the investor Wherever considerable changes in demand take place the profits of all businesses able to take advantage of the change are likely to contain an element of surplus

The war conditions with the enormous Government demands the general shortage of certain goods and the unprecedented price changes enabled many producers to make profits far above the pre war level, and far higher than were necessary to maintain output Temporarily many producers found themselves in the position of monopolists and faced with an extremely rigid Government demand, were in a position to make almost any terms they wished

The attempt to impose a special tax upon war profits originated in the neutral Scandinavian countries in the early spring of 1915 to reach the enormous profits that exporters of food stuffs in those countries were making from their sales to Germany By 1917 a special tax on high profits had spread in one form or another to thirteen countries

In the first instance the suggestion was generally to tax profits which might be directly traced to war conditions, but the technical difficulties of distinguishing war from other profits generally led to the adoption of a tax imposed upon all abnormally high profits made during the war period All people making exceptionally high profits, it was held, were specially fortunate

and could be subjected to special taxation without hardship The two great problems were to determine the normal rates of profits beyond which profits were to be liable to the special tax and the method of taxing the excess

The first problem was both difficult and important In the attempts to tax land values we saw that one great difficulty was to isolate the wealth that might be re garded as surplus The difficulty in the Excess Profits Tax led the Government to abandon the attempt to discriminate between war and other excess profits, but even so it was difficult to determine what part of profits was to be regarded as excess The most usual method was to take the average profit over a number of pre war years to regard the rate earned then as *normal* and to exempt the normal rate In this country the standard rate was based on the average profit of any two of the last three years before the outbreak of war With cer tain qualifications profits beyond this were liable to the Excess Profits Tax This method was not perfect Really not only past rates of profits but future expec tations should have been taken into account in ascer taining the normal rate Where firms in the past had maintained high rates through exceptionally good management they benefited because a higher rate of normal profits was exempted but firms introducing greater efficiency had to pay away a large part of their increased returns due to the greater efficiency in tax There was consequently less incentive to new economies New firms had to be allowed a *conventional* rate of normal profits free from tax In such cases it was more difficult to decide on the normal rate The most that

could be hoped for was to find a rate that represented fairly closely the normal rates of different industries and as it was impossible to vary the rates in proportion to the efficiency of the different firms the incentives to individual economies were again reduced

The second question was how after the system of isolating them was settled the excess profits were to be taxed The English method was to regard the excess profits of each firm as an individual unit and to tax it at rates varying from 50 per cent in 1915 to 80 per cent in 1917

The English system had the great merit of simplifying the difficulties of collection The tax had to be paid by each firm before profits were distributed the tax was at a flat rate and the individual shareholders had no claims for exemptions or abatements This was from the tax collector s point of view a great advantage and the enormous revenue yielded by the tax bears witness to its efficiency as a means of raising funds The system however, is not above criticism It took no account at all of the individual position of the share holders who ultimately paid the tax If A had a pre war income of £500 drawn from different sources even if his total income had been largely reduced by war conditions he would still have had excess profits tax deducted from any share he might have in the profits of a firm liable to the tax Further his share in the profits would be taxed at the same rate as B s with an income of £5000 or C s with an income of £50 000 In some countries attempts were made to adapt the tax to individual ability but such attempts necessarily reduced the efficiency of the tax as a means of collecting revenue

§ 12 *The E P D and Production* From the productive standpoint the tax was generally subjected to criticism of two kinds On the one hand it was claimed that the tax was regarded by producers as an addition to cost and was added to price with the net result that in addition to the general difficulties involved by the rising prices the Government as chief purchaser was compelled to pay a large part of its own tax Apart from this it was held that the very heavy rates of tax led to wasteful production and to considerable indirect evasions

In examining the first of these criticisms it should be remembered that the theory of the tax was that a full normal rate of profits should be exempted and the tax absorb only a high percentage of profits beyond that amount If this exemption were satisfactorily carried out the exempted rates should have been sufficient to maintain production and in these circumstances there was no reason why the producers should have been in a position to charge higher prices after than before the tax The definition of normal profits for individual industries and firms was however a real difficulty and it is further, probable that after three years of war what were regarded as ' normal profits had reached a considerably higher level than in 1914 In this case the demand for higher net profits in conjunction with the extremely urgent Government demand backed by an unlimited vote of credit may have led to an appreciable shifting of the tax in the latter years

Certainly however there seems reasons for thinking that the effect of the E P D in raising prices directly has been popularly exaggerated The view so often put

forward of the patriotic business man compelled by an ill judged tax reluctantly to raise prices which otherwise, it is implied would have been stringently kept down in the public interest seems hardly supported by theory or fact The theory of the tax was that producers generally would take full advantage of their opportunities to raise prices whether they were taxed or not Certainly neither the short English nor the longer American experience of war conditions before the imposition of an E P D suggests any reason for substantially modifying that view The halving of the English tax in 1919 while boom conditions still continued apparently checked neither profits nor prices Nor were farmers in this country (who were exempt from the tax) notable for the relative lowness of either prices or profits It is probable that the full monopoly prices would have been charged whether the duty was imposed or not and it was only when the duty gave an opportunity for charging more by the threat of checking supply that it raised price directly

The indirect effects of the tax in raising price were probably more important We have already said that the method of exempting normal rates differentiated to some extent against new and growing businesses In all firms liable to the tax a large part of the loss due to extravagance or laxity of management fell on the Government on the other hand, returns due to increased economy were shared by the tax collector There can be no doubt that the motives to economy and enterprise were reduced On the other hand the high rates of tax meant that liberal allowances had to be given for any expenditure on repairs, renewals, or, in fact, any kind

of general expenses Although the war conditions to some extent limited the power of producers to take advantage of this there can be no doubt that expenditure on these lines was carried to a point which would not have been contemplated had not a large part of the cost been in effect borne by the Government All of this expenditure was of course not wasted and some of it undoubtedly added permanently to the capital value of the country but it is probable that much of it (like most subsidised expenditure) would have been extravagant at any time, and was specially so given the urgent war demand for other goods

The enormous yield of the Excess Profits Tax during the war atoned in practice for many of its deficiencies As a permanent tax the objections to it would be stronger and its yield in more normal circumstances would certainly be less In the special case of war profits the fact that the tax was not adjusted in any way to the wealth of individuals was accepted—but as a permanent tax both these and the exclusion on administrative grounds of certain classes (e g farmers and professional men) would be more open to criticism Again as a permanent problem the difficulty of exempting normal profits would present even more complications under war conditions the demand for commodities was so urgent that in all probability the general course of production was unaffected by slight maladjustments of the tax under normal conditions however the tax might result in quite arbitrary changes in the general course of industrial development In peace as in war such a tax would almost inevitably differentiate against rising businesses, and tend to favour the more standardised

and unenterprising concerns while in periods of trade prosperity there would be the incentive to extending capital expenditure beyond the normal point as an indirect method of evading the tax Where the rates of tax were low these effects would not be likely to be important—but in this case the administrative charges would probably swallow up large parts of the yield Our war tax was finally abandoned some two years after the Armistice

CHAPTER V

TAXATION AND DISTRIBUTION

§ 1 *Existing Distribution* In 1918–19 (the latest figures available) the analysis of the Income Tax returns shows that of over $5\frac{1}{2}$ m incomes over £130 assessed to tax in the United Kingdom nearly a half fell between £130 and £160 and nearly $\frac{4}{5}$ between £130 and £200 The income between £130 and £160 amounted to about $\frac{1}{7}$ and that between £130 and £200 to just under $\frac{1}{3}$ of the total distributed income returned for tax In other words of the assessed income $\frac{1}{3}$ was divided among $\frac{4}{5}$ of the population in incomes of less than £200 while at the other end of the scale about $\frac{1}{4}$ of the total income went to $\frac{1}{70}$ of the taxed population in incomes over £2500 The inequalities which these figures suggest are emphasised if it is remembered that the undistributed income (i e the undistributed profits of public companies) which amounted to about 12 per cent of the distributed income probably benefited primarily the wealthiest class while in the years to which these figures apply huge sums had been paid in Excess Profits Duty before the incomes were paid out to individuals

These figures are probably not an accurate summary of all incomes but as far as they go they bring home the

fact that the country's reserves of wealth are concentrated in relatively few hands and both large contributions to saving and large contributions to taxation have to be met directly or indirectly out of these reserves if even a poor standard of life is to be maintained by the majority

§ 2 *The Modification of Taxation* Until about fifteen years ago English taxation (and incidentally the taxation of most other countries) probably emphasised rather than reduced the original inequalities of incomes It was a superstition of English finance that half the revenue was to come from taxes on commodities and as these taxes fell mainly on staple articles of consumption they absorbed larger proportions of the incomes of the poor than of the rich It is calculated that in 1903–4 indirect taxes absorbed 9 per cent of incomes of £50 6 per cent of those of £100, but only 2 5 per cent of incomes of £1000 and less than 0 1 per cent of incomes of £8000 The regressive indirect taxes were not appreciably offset by the progression of the direct taxes until after 1909 Until that year there was no graduation of Income Tax on incomes over £700 Below that amount certain abatements were allowed while incomes of less than £160 were exempt but all incomes over £700 paid at the full rate which varied between 2d and 1s 3d in the period 1875–1909 No incomes paid at more than these rates As far as the tax system as a whole was concerned the progression of the Income Tax offset the regression of the indirect taxes on incomes between £160 and £700 but on incomes beyond that amount the annual taxation was

slightly regressive In the case of inherited incomes this was corrected by the graduation of the Death Duties

Since 1909 there has been a double tendency to increased progression On the one hand a smaller proportion of total revenue has been raised from indirect taxes (in 1921 only 29 per cent as compared with 47 per cent in 1908), while the progression of the direct taxes has steadily increased

In 1909 a Super Tax of 6d was imposed which was payable by all incomes over £5000 on that part of their income which exceeded £3000 In the 1914 Budget further graduation of the Income Tax and graduation of the Super Tax were introduced Four months later came the outbreak of war

After August 1914 the rates of Income Tax and Super Tax steadily increased New graduation was introduced new abatements and allowances given, but the rapid growth of rates meant that anomalies crept in and injustices which were unimportant when the rates were low became intolerable as the rates increased In 1920 the Royal Commission on the Income Tax recommended various changes which were intended to improve the working without altering any of the essential features of the tax

The chief points of the new system are —

1 To allow a minimum of exemption varying with family responsibilities to all taxpayers

2 After allowances have been deducted from income, to tax the remaining income at two rates—the first £250 at half the standard rate, the remainder

at the full standard rate (until April, 1922 6s, at present 5s in the £)

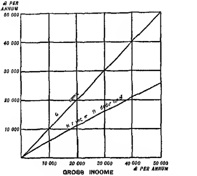
3 To impose Super Tax on incomes over £2000 This rises from 1s 6d on the incomes between £2000 and £25,000 to 6s on the incomes over £30 000

The result of the change is that the rate of tax now rises fairly smoothly from the lowest to the highest incomes which pay a rate of 11s on the parts of income which exceed £30,000

The development of graduation in the American Federal Tax is even more striking for progression was practically unknown in Federal taxation before the Income Tax of 1913 The maximum rate in 1919 (which amounted to 77 per cent of incomes over $1 m) was even higher than in this country but it was much more of a "fancy rate" than the English maximum both because it fell on a much smaller proportion of the total income and because it was much less effectively administered

There can be no doubt that the present method of distributing the burden of taxation does more to modify directly the inequalities of income than in pre war days The accompanying diagram shows how in 1918 the proportion of income paid to income tax increased as incomes rose so that the level of net incomes (i e incomes minus tax) rose much more slowly than that of the untaxed incomes This tendency was emphasised by the increased rates of death duties and probably by the taxes on profits but was modified by the indirect taxes which still absorbed a larger proportion of the smaller incomes

§ 3 *The Inequality of Incomes and Saving* We showed in the last chapter that while heavy taxes on small incomes will undoubtedly reduce necessary expenditure, if heavier burdens of taxation are thrown on the larger incomes the possibility of these eating into the supplies



of new capital increases An immediate relief to the small incomes may be gained at the expense of new saving

In the nineteenth century saving was extolled as the most necessary of the economic virtues During that period the extreme inequalities of wealth put any substantial contribution to saving out of the reach of all but the wealthiest and these made the vast accumulations of capital to which—among other things—we

owe the railways of the world With the small total income relative to population of that century these capital accumulations were only made possible by the extremely low standard of living of the majority The whole of the financial literature of the period shows the general fear that if the State used its weapon of taxation to raise this standard even to the negative extent of throwing the cost of the Government e dead weight expenditure upon the rich this must imperil our economic development That this tradition persists to some extent is shown by the number of people who even now feel something approaching instinctive horror of any member of the traditionally poorer classes with the means to gratify a taste for any of the minor amenities of life

On the whole however the tradition of saving has not come so easily to the present generation The general criticism that the sacrifice of generations of workers to the interests of future production involves a fundamental confusion of means and ends has been given new point by the increasing demand for a higher standard of living, and a less arduous working life by those whose compulsory abstemiousness made the saving of the past possible On the other hand even from the productive standpoint the criticism has arisen that the generations which built railways and neglected housing developed machinery and kept educational expenditure at the minimum were developing material at the expense of human capital to an extent which probably ultimately reduced production, and reduced it at an enormous cost in terms of human suffering

There can be no doubt of the force of this criticism

The nineteenth century view of economic progress neglected the possibility of the development of human resources and as we argued in the first chapter much of the present social expenditure is essentially capital expenditure which is likely to prove reproductive in the fullest sense This does not however, dispose of the argument that imposing very heavy burdens on the rich may in some circumstances have injurious results upon the incomes of *all classes* and it is worth analysing the matter further

§ 4 *The Effects of Reduced Saving* 1 If taxation transfers wealth which is normally consumed by the rich to the poor the immediate result is that the rich lose and the poor gain As the transference is likely to increase the utility derived from the income the gain will probably outweigh the loss The transference may react favourably upon productivity by raising the standard of efficiency of the poor and this result is perhaps more probable if the subsidy is given in the form of goods and services the consumption of which it is particularly desirable to encourage In this case there may ultimately be some indirect gain to the original taxpayers from the increased prosperity of the country

2 If as a result of the tax wealth that would otherwise be invested by the rich is transferred to the poor the gain may still outweigh the loss and in some cases (e g cases of obvious under consumption by the poor) is almost certain to do so It should however be realised that in this case the loss from checking the investment may react on classes other than the original taxpayers If, for instance investment in textile machinery is

checked the taxpayers will lose any future income that they would otherwise have derived from their investment But the matter does not end there The development of textile machinery generally facilitates and ultimately cheapens the production of textile goods, and the loss from any holding up of this falls not only on the original investors, but on all consumers To take another case It is arguable that during the nineteenth century the real interests of the country would have been better served if less had been invested in railways and more in housing Better housing would certainly have increased the comfort and might have increased the productive efficiency of the poor but on the other hand anything that checked the development of transport would have kept up food prices in this country and the loss from dearer food would have to be set against the gain from better housing in calculating the net gains of the change both to the poor and to the country as a whole

3 In these cases there is no reason to think that the transference would have any immediate effect upon employment The people who without the tax would have been employed in building railways might after the tax be employed on housing and the sum paid in wages in both cases might be equal If however, the tax not only transferred wealth but discouraged production (e g not only absorbed a part of the largest incomes but discouraged the development of these incomes) it would mean that demand at some points would be checked without compensating increases at others This must reduce the total demand for goods and services and ultimately react on employment

4 Where taxation means a considerable reduction of saving it is possible that part of the loss may be shifted from the original taxpayers to other classes Capital is essential for industry A shortage of capital means generally that the competition for the smaller supply forces up its price and the interest rate rises This means that capital will not be applied in the less productive uses which cannot afford to pay the new price, the development of industry at some points will be checked and employment at those points will be reduced Further, as a higher rate will have to be paid for the same amount of capital where it is still used this will absorb a larger proportion of the value of the finished products than before If these are sold at their old price this must mean that a smaller sum is left for other expenses including wages If prices are raised to meet the additional cost of the necessary capital this will serve to check demand and to react further upon employment Where markets are booming and world prices rising additions to price hardly seem to affect demand, and during the abnormal war conditions people began to forget that higher prices normally check demand The end of the price boom and the return to more competitive conditions have again made it clear that any factor which keeps up costs is likely to prove a serious check upon the development of production

A check to production means an immediate loss to the workers through increased unemployment A long depression is almost certain to result in some cutting of wage rates The result will vary from trade to trade and period to period, but on the whole a prolonged

shortage of employment is likely to lead to the acceptance of lower wage rates in the hopes of getting production started again. If this happens the final result will be that as wage rates are somewhat reduced and interest rates somewhat increased the burden of the tax (although it is still imposed on the original tax payers) will be partly borne by other classes. The point to emphasise is that the real evil of checking saving is not only that it will deprive the capitalist of a future income but that it will hit all consumers where it checks the most economical development of production, and is likely ultimately to be shifted in part on to the wage earners by checking employment and reducing wage rates. To attempt redistribution by methods which result in the shifting of a considerable part of the burden of the tax must ultimately be self destructive.

This suggests that it is impossible (given the existing organisation of industry) for taxation to improve the position of the poor indefinitely by transferring wealth to them from the rich, nor where a country is taxed to a point where the taxes react upon production is it possible for any class to escape entirely the burdens of the country's dead weight expenditure. The argument really comes to this. While all classes ultimately stand to gain from the most economical production all classes stand to lose in some degree from anything that reduces it. Further as capital and labour are 'jointly demanded' for production anything that checks the supply of one will tend to react adversely upon the other. If when capital is reduced there is a compensation to labour (as there is when the capital has been transferred to other uses directly benefiting labour) the gain may be

greater than the loss But unless there is compensation of this kind, part of the burden is likely to fall ultimately on all classes of producers

§ 5 *The Shifting of Taxation* One point should be made clear Even if taxes on high incomes may (when they cut into the supply of capital) gradually be partly shifted on to other poorer producers it is not immaterial from the point of view of distribution whether the initial burden of the tax falls on the rich or on the poor If it falls on the rich it rests on them until it can be shifted and as shifting can normally take place only through the readjustment of supply this takes time As there is nothing mechanical about the working of economic forces probably part of the tax tends to ' stick where it falls " Further to identify the rich with the capitalist and the poor with the wage earning ' class is only a rough approximation Some large incomes such for instance as incomes from the rent of land or incomes from securities carrying fixed rates of interest, will not be favourably affected by higher interest rates and they will be permanently reduced by the full amount of the tax It is only the parts of income that are able to take advantage of the more favourable rates that follow a shortage of capital that will be able to get some compensation for the real burden of the tax Also, of course the advantage will not be restricted to taxpayers and small investors will gain even if they have not paid the tax

How far it is possible for those incomes to shift the real burden depends on the extent of the shortage of capital the conditions of demand and the ability of the

workers to resist reductions of their wage rates On the whole the bargaining advantages are probably on the side of the capitalists Industrial policy is controlled primarily in the capitalist interest which in itself gives them a tactical advantage They can afford to wait before resuming production and until satisfactory readjustments are made the supply of capital can be further reduced as far as industry is concerned both by the extension of non industrial investment (such as Government securities) or by investment out of the country The cutting of wage rates on the other hand, may lead to a voluntary organised withholding of labour by trade union action, but the position of the workers is weakened by the fact that, as they have no other openings for employment, they cannot temporarily adjust the supply of workers until the market improves The relative weakness of the workers position makes it particularly important that the onus of "shifting the tax" should not rest upon them

§ 6 *Professor Rignano s Scheme* Before leaving the question of distribution it is worth looking at a special form of inheritance tax which it is claimed is likely to discourage indirectly as well as directly some inequalities of income We saw in Chapter IV that where inheritance taxes penalise the inheriting of large properties this may be expected when the rates are appreciable, to encourage the more equal distribution of property while by absorbing a proportion of individual inheritance it does directly prevent some of the more striking inequalities of inherited wealth A rather more elaborate scheme has been developed by Professor Rignano wh ch

it is claimed has the double merit of leading to greater equality of income by preventing the indefinite handing down of inherited wealth from one generation to another, without discouraging production

Professor *Rignano s main idea is that* a tax on inheritance should be 'progressive in time The rate of tax should increase with the number of times that the taxed property changes hands through inheritance To take an instance of the possible working of the scheme If A left property which he had accumulated himself to B the original tax might absorb one third of this If B at death left this property and in addition property that he had accumulated himself the tax would absorb two thirds of the property that had been inherited from A but only one third of the property accumulated by B At the death of C (to whom B s property was left) the tax would absorb the whole of the remainder of the property which had originated with A two thirds of the remainder of that which had originated with B and one third of that which had been accumulated by C In this case the whole of any accumulation of wealth would be absorbed by the State after it had passed through the hands of two heirs but of course in practice the rates of tax and the length of time that would elapse before the final absorption of the property could vary with the economic and social conditions and the financial needs of the taxing country

A tax of *this kind* would seem less likely over a long period to check accumulation than a death duty of the accepted kind yielding equal returns to the revenue The slowness with which the heavy rates of tax come into force would probably mean that there would be

less discouragement for any individual to accumulate wealth while the fact that inherited wealth could not be counted upon to any large extent to provide for a family after death might be a positive incentive to accumulation As Professor Rignano points out from the point of view of providing for his children, even if a man has inherited wealth, the sums he saves himself have a much greater value than equal sums that he may have inherited A man who inherits money to day may count on this to provide for his children and knows further that any increase that he makes to the property by his personal exertions is likely to increase the rate of tax on his estate as a whole A man who inherited under the new scheme would have stronger motives to accumulate wealth himself both because he would only be able to hand on a small proportion, or possibly none at all of his inherited wealth, and because the amount that he left would not increase the tax rates on his property as a whole

There would certainly be considerable technical difficulties in the administration of any new tax of this kind It has been suggested that to some extent these might be reduced by exempting a minimum of inherited wealth from the tax, which would have a considerable effect in reducing the number of those coming under it On the other hand the rights of heirs to dispose of inherited capital would have to be strictly limited and defined to prevent undue evasion There seems, however no obvious reason to think that the tax would necessarily be more difficult to work than any of the other great direct taxes Its great advantage is that while it falls very heavily on the old accumulations of wealth which

already exist and do much to account for the existing inequalities of income, it falls much less heavily on new wealth while by reducing the possibility of depending on inherited property, it increases for some classes the incentive to accumulate new wealth

CHAPTER VI

OTHER ECONOMIC CONSIDERATIONS

§ 1 *Capitalisation of Taxes* Where a tax threatens to reduce the supply of any necessary economic service or commodity it is usually shifted away from the producers, even if it is imposed on them in the first instance Where no readjustment of supply is possible the tax falls on the owners or producers of the taxed commodity A tax upon rent does not affect the supply of land, and a tax upon economic rent rests on the landowner What is more, if the original owner sells the buyers will know of the existence of the tax and the price they are willing to pay will be correspondingly reduced! If, as the result of taxation the net return from a piece of land is reduced by 10 per cent the selling value of the land will be proportionately decreased and the full burden of the capitalised tax will fall on the sellers Future buyers will be responsible for the annual payment of the tax, but it represents no real burden to them as it has been allowed for in the purchase price To remit a tax of this kind after a period of years amounts to giving a bonus to the owners of all property which has changed hands since its imposition The history of the English Land Tax affords a case in point It is an old tax, which after many vicissitudes settled down into an

annual rent charge which was taken into account by every purchaser of land It represented no burden on new owners and even where the land had not changed hands by sale it was a charge to which people were thoroughly accustomed In 1894, when the tax was reduced to a maximum charge of 1s in the £ entirely remitted for those with incomes of less than £160 and halved for others with small incomes the result was in effect a bonus from the State to the beneficiaries under the Act A tax of this kind may result in anomalies when it is first imposed, but to remit it may result in other anomalies

In the same way a tax which falls on surplus profits should theoretically rest permanently on the original owners of the taxed profits by reducing the selling value of their businesses as compared with other investments In the case of the American Excess Profits Tax the tax was graduated rising as the rate of profits increased If the rate earned by one company was 50 per cent while that of the normal company was 10 per cent the selling value of shares in the former would (other things being equal) be about five times that of those in the latter If the tax reduced the surplus profits until the net returns were only 20 per cent it is obvious that (if the tax was expected to be permanent) there would be a readjustment of the selling values of the shares Purchasers would take the tax into account as a special charge on certain shares and the real burden of the tax would tend to rest on the owners of shares when the tax was first imposed The great difficulty of isolating surplus profits makes it possible that in practice some shifting of these taxes may take place

§ 2 *Shifting of Indirect Taxes* Economic forces only work themselves out gradually and even where a tax is imposed with the expectation and intention that it will be shifted away from the original taxpayer this shifting may take time In the case of a tax imposed on a commodity produced in the taxing country the usual procedure is for the tax to be collected from the producer, it being expected that he will refund himself by a proportionate increase of price to the consumers In the first instance however, he may be on the horns of a dilemma Where the tax is unexpected the industry will be organised to satisfy demand at the old price If the price is raised this is likely to check the demand both by increased economy in the use of the taxed article and by encouraging wherever possible, the use of untaxed substitutes Where the decrease in demand is considerable the result may be that a considerable proportion of fixed capital, etc , will be thrown out of production and entail considerable loss to producers In these circumstances it is possible that it may be to their interest to increase price temporarily by less than the full amount of tax accepting a lower rate of profit in preference to cutting off a considerable part of the demand The producers position is weakest where the demand is elastic and where it is difficult to adjust supply without loss In any case if the net returns are reduced by the tax the industry is not likely to attract new investments until price has recovered sufficiently to show a return approximately equal to that in other similar investments Supply will gradually readjust itself until the burden is shifted on to the consumers

Actually we are accustomed to a new or increased tax

being followed by an immediate proportionate increase in price not only for the supplies which actually pay the new rate but for any reserves which may have been held by the retailers or wholesalers This is probably partly accounted for by the fact that the articles selected for taxation are articles of inelastic demand Further, as the taxed articles are produced on a large scale, the producers are generally strong enough to stand an immediate loss, and may hope that if a fall in consumption and consequently in tax revenue can be shown as a result of the tax some modification may result In some cases of semi monopolistic industries it seems that taxes may be used as an excuse for charging unnecessarily high prices which might otherwise rouse public opinion against the producers

In all these cases it is the initial disturbance and hardship of the tax that is likely to be greatest and there is something to be said on these grounds for the maxim that 'an old tax is a good tax'

§ 3 *Taxes on Developing Industries* A tax imposed on a commodity which can be produced more economically on a large scale than a small may, by checking the development of the industry force up price to the consumer by more than the amount of the tax Where production is on a smaller scale the cost of production per unit of output will be increased, and price to consumers is likely to rise ultimately both by this sum and the amount of the tax Such taxation is essentially wasteful, for the loss to the taxpayers is greater than the gain to the revenue In practice probably the more important instances occur not where existing economies

are lost by the reduction of the amount produced but where a tax by checking further expansion delays the introduction of possible new economies. The result is likely to be more important for growing industries than for those that are well established. A general case against a tax on a developing manufacturing industry can always be made on these grounds. In the past the more popular policy as far as national industries of this kind are concerned has been to give direct or indirect bonuses rather than to subject them to special taxation, but it is possible that a general tax on industry—such as the French and German "taxes on turnover"—fall specially heavily on these industries.

If taxable commodities can be found which can be produced more cheaply on a smaller than a larger scale, a tax by reducing output, might permanently raise price to the consumers by less than the amount of the tax. Such a tax is obviously economical for it takes less out of the pockets of the consumers than it yields to the exchequer.

In this connection it is worth noticing that a tax on a raw material is open to the general objection that by adding to the cost of manufacturing industries, it may check development and cause a further increase (or at least delay a decrease) of price to the consumer. Further, as raw materials normally pass through several stages and several hands before they reach the consumer who ultimately pays the tax not only the original amount of the tax but also an additional interest charge on this amount is likely to be ultimately added to price. The tax will be an addition to cost to everyone who handles the taxed material, and the normal rate of return will

naturally be demanded upon it A tax on a raw material is generally less economical than a tax on finished goods

§ 4 *Import and Export Duties* Taxes which are imposed on imported and exported goods have a practical advantage in that they are normally easy to collect, but they have appealed to popular favour mainly on other grounds All customs duties seem to offer the tempting possibility of making the foreigner pay while import duties have achieved popularity as a method of 'protecting home industries' An import duty, it should be noticed, is protective only if it differentiates against foreign producers by imposing a tax on imported products without a corresponding excise duty on home produced supplies of the same article Free trade countries may use non protective import duties for revenue purposes without inconsistency

Our discussion of taxes on goods produced in the home markets suggested that these were ultimately paid by the consumers In the same way one would expect that a tax on imports would fall on consumers in the taxing country On the whole it seems reasonable to assume that this is likely to happen even more quickly than with a home produced article for the foreign producer may have alternative markets to which he can turn if a rise in price reduces his sales in the taxing country It is possible that if the taxing country is the only available market and if a rise in price means a rapid fall in demand the producer may be temporarily induced to cut his prices to keep up his sales but unless he was previously making monopoly profits ' supply will gradually be readjusted until prices recover In practice,

few cases arise in which a country is in the exceptionally strong position of being the only available market for a foreign commodity and at the same time having a very 'elastic' demand for it—in fact it is extremely doubtful if a single historical case can be cited where there is reason to think that 'the foreigner' paid any considerable part of any import duty

In the case of an export duty the position of the producer is weakened because he may find himself competing in foreign markets with other producers who are unhandicapped by taxation Where this happens, if sales are to continue the price of the taxed products will have to fall into line with the price of the competing supplies on the foreign markets which means that the producers will have to pay the tax If however, the taxing country has a monopoly, or even a partial monopoly of supply and if the demand is urgent, the foreign consumers may pay a price increased by the amount of the tax Cases of this kind are not unknown although they are exceptional Certain countries have had monopolies of raw materials urgently needed by other countries During the nineteenth century English manufacturers were in an exceptionally strong position in their foreign sales, as they were practically the only considerable producers of many manufactured goods At the end of the great war England was in an exceptionally strong position with regard to her exports of coal In all these cases it is probable that part of the direct burden of an export duty would temporarily at least have fallen on the foreign consumers Export duties however have never been as popular as import duties It is realised that they must handicap the home producer

that even in the most favourable circumstances they are likely to cause some check to output as a result of a rise in price while over a longer period an export duty may be an important factor contributing to the development of alternative sources of supply or possibly to the use of substitutes thus ultimately weakening the position of the producers in the taxing country

§ 5 *Customs Duties and Foreign Exchange Rates* There is a further consideration to be taken into account with regard to the incidence of import and export duties In buying and selling between different countries not only the price levels of the two countries have to be considered but also the value of the currency of the one country in terms of the other It is obviously necessary before coming to any rational conclusion as to the profitableness of buying goods in America to know not only the price in dollars in America and the price in sterling in England but also the value of dollars in terms of sterling Other things being equal, the cheaper the dollar in sterling the cheaper it will be for an English man to buy from America Now the value of dollars in terms of sterling depends primarily upon the relative demands for them Anything that increases the demand in England for American money will push up the value of the dollar in sterling—anything increasing the demand for English money in New York will push up its value in terms of dollars A tax on goods bought and sold between the two countries may have an effect upon the value of their currencies in terms of one another by affecting the amount of the payments that have to be made

In the case of an import duty the result is likely to be that the imports of the taxed goods will be checked. The taxing country will have fewer payments to make abroad; its demand for the currency of the exporting country will be checked and the relative value of this money will fall. That is, if England is the taxing and America the exporting country the dollar will fall in terms of sterling. This would appear at first to be to England's advantage because even if her consumers now pay the old price for the taxed goods in dollars this represents a slightly lower price in sterling. The consumers are thus indirectly relieved of part of the burden of the tax. It has been argued that there is a general presumption in favour of import duties on the grounds that they tend to turn the foreign exchange rates slightly in favour of the taxing country.

It should, however, be realised that this will only be important where the effect of the tax is a very considerable check to imports. Further, as has been sufficiently demonstrated during the last two years, anything pushing up the value of the currency of one country in terms of another has disadvantages as well as advantages. When our currency rises in value it certainly makes it cheaper for us to buy from abroad, but it makes it dearer for foreigners to buy from us. Our gain as consumers is partly illusory, for it is achieved at the expense of our export trade with its consequent reactions on production, profits and employment. Export duties, which tend to check exports, have, of course, the opposite effect on the foreign exchanges in the first instance. The cheapening of the currency has some effect in counterbalancing the direct handicap

of the export duty in selling abroad, and is a small bonus to other exporting trades On the other hand, it makes it dearer to buy from abroad As most countries find it to their advantage to buy some goods from abroad and to sell others in foreign markets there is a general presumption that any arbitrary interference with this course of trade will ultimately mean more loss than gain

The same general presumption holds against any indirect tax on a home produced article and the argument must not be taken to mean that customs duties may not be among the best available indirect taxes It does however mean that the general arguments against all indirect taxes apply to them that the only circumstances in which part of the direct burden is likely to be forced even temporarily on the foreigners are quite exceptional while even in these circumstances the direct gain is likely to be counter balanced by indirect reactions either on our import or export trade

§ 6 *Protective Duties and Revenue* Where protective duties are concerned, financial considerations are generally secondary and questions of commercial policy hold the field In political discussion at least, however the double advantages of opening up a suitable field of taxation and at the same time encouraging commercial development are generally held out

We showed in our earlier discussion that an excise duty may be specially injurious where it checks a developing industry that is likely when carried on on a larger scale to show considerable reductions in cost A further application of the same argument shows that

in certain circumstances an immediate bonus to speed up the development of industries may lead to a more rapid introduction of economies and ultimately prove a real gain There is no occasion to dispute the theoretical validity of cases of this kind and one way of giving a bonus to a home industry is to put a customs duty on imports of the article it is intended to encourage In the first instance this will almost certainly raise its price but if the industry is capable of development it is possible that the commodity may ultimately be produced more, or at least equally, cheaply by home producers It is even possible that the country may have special facilities for this kind of production, although its development has been delayed by the continual under selling of foreign competitors with the advantages of being first in the field

The original defence of protective duties of this kind was made for the special case of countries in a stage of transition between agriculture and manufacture The argument is certainly strongest for these cases and had a special application in the nineteenth century when England which was practically the only country with developed manufactures was in a particularly strong position in competition with Germany and the U S A who were then in the transition stage More recently India has put forward a claim for a protective tariff on rather similar grounds, while it is not improbable that Irish industries will make the same claim in the future

Protective duties of this kind should obviously be necessary only for a term of years, for, unless the in dustry becomes self supporting fairly rapidly the case in favour of the duties breaks down The suggestion of

their original exponent was that there should always be a definite time limit with a maximum of ten years In practice however, the repeal of duties originally imposed to protect an infant industry ' is bitterly opposed and few countries which have once committed themselves to a protective policy have been strong enough to resist the appeals of the vested interests to maintain the duties

Strictly, of course, a developed manufacturing industry has no claim of this kind to protective duties But the arguments applied originally to infant industries have been given a further application on the grounds, firstly that a further extension of the scale of production may lead to further economies and secondly, that industries may need protection against unfair foreign competition, by dumping Both these arguments may have force in certain cases and the second has been given a special application in the case of key industries" They are certainly open to very obvious objections As far as the first is concerned while there is very little evidence to show that once an industry is established protective duties lead to increased economies of production there is certain evidence that they make the monopolisation of the market easier and play into the hands of monopolistic producers at the expense of the consuming public Even where foreign dumping exists (and there seems reason to think its prevalence is exaggerated) it is practically extremely difficult to formulate legislation which can be counted on to hit the dumped surplus only without being unduly obstructive to trade generally, or being used as a means of protecting powerful home producers against legitimate competition

The point that really concerns us here is that where

a tax is levied for protective purposes it must, from the nature of the case, be unsuited for general revenue purposes A tax as far as it is protective cannot yield revenue Where the declared purpose of the tax is to put the home producer in a position to oust foreign competitors, even if the tax yields revenue at first, it must, if it is successful prove ultimately unproductive Nor can taxes on dumped surpluses ever be counted on to yield a steady and dependable yield to the exchequer

CHAPTER VII

LOCAL FINANCE

§ 1 *The Functions of Local Governments* The government of this country is divided between the central and local governing bodies and the local bodies have their own financial problems It is not easy to draw a hard and fast division between the spheres of the central and local authorities and to say that while some forms of expenditure are matters of general importance and should be left to the central authorities others are only of local importance and should be left to the local bodies In practice what are regarded as the proper objects of local expenditure vary from country to country with geographical conditions historical associations and political traditions, and vary from period to period in the same country as conditions alter and as the efficiency of the local authorities changes There are some kinds of expenditure which are clearly national in scope and can be much more efficiently administered nationally (e g services for national defence) others are clearly local and capable of more efficient local administration (e g town gas supplies) but some may be regarded as both national and local (e g roads and police) or may be of national importance and yet capable of more efficient local administration (e g many public health services)

The whole question is further complicated by the great differences in the efficiency of different local authorities and the great variations in the resources of the different districts which the local governing bodies control

Actually in this country local administration covers a large variety of services A part of the necessary funds is drawn from the localities concerned, the remainder is obtained in a variety of extraordinarily confusing ways from the general revenue

§ 2 *Methods of Local Taxation* The Poor Rate—the oldest surviving local tax—dates back to the sixteenth century, and gradually, after a complicated history which need not detain us settled down as a rate charged on the annual value of immovable property Rates for other expenditure have been gradually assimilated to the Poor Rate and our local taxation is now obtained through rates imposed upon the annual value of immovable property The property liable to local taxation includes land buildings and fixed machinery although, as far as the last is concerned, there does not seem to be any uniformity of practice The rateable value of properties for poor rate purposes was defined in 1836 as the rent at which the same might be reasonably expected to let from year to year deducting there from the probable average cost of the repairs, insurance and other expenses necessary to maintain them in a state to command such rent" Since the Agricultural Rates Act of 1896 agricultural land (apart from farm buildings) has been assessed at half its annual value only The estimated necessary local revenue is distributed at an equal rate in the £ on the rateable value

of the district The rates are levied on the occupiers except in the case of some small properties where the rates may be paid by the landlord

As the position now stands occupiers of land and buildings are called upon to pay rates levied on the annual value of the occupied immovable property the amount of the rates in the £ being determined by the cost of the local services the proportion of that cost borne by the central funds and the total rateable value of the district

§ 3 *Incidence of Local Rates* The annual value of a house (or any other property) on which rates are levied includes the annual value of the land on which it is built and the annual value of the building itself To use technical terms it includes both site value and building value Rates fall on both site and building values and are not imposed separately A general tax on site values tends to fall on the owners of the land for anyone taking the land has this payment to make in addition to any rent charge and consequently the rent he can afford to offer will be reduced The supply of land will not be curtailed as a result of the tax and the tax tends to rest permanently on the landowner

A general tax on building values will tend to rest largely on the occupiers unless the buildings are used for business purposes when it will tend to be shifted forward on to the consumers served by the business In neither case will it rest permanently on the owners of the buildings for unless a net rent be charged that will show a normal return building will be curtailed until the shortage of the supply leads to an increased

return If, for instance, houses were built in the expectation of letting at an annual rental of £45 exclusive of rates but sudden heavy increases in this charge meant that the class of occupiers for whom the houses were intended could only afford to offer £35 a year, new houses of this class would hardly be put on the market until the demand recovered As far as new rates are concerned however owners of existing buildings may be in a weak position and may be compelled either to accept a lower net rental or to have their houses empty on their hands just as in the case of a new tax on any commodity the producer may have to choose between accepting a lower price for his supply or leaving a part of it unsold In the case of houses the position of the owners is weak as the supply of houses takes a particularly long time to readjust itself and the owners of old houses may be compelled to bear part of the burden of new rates for long periods

In all cases these tendencies work themselves out slowly The fact that the tax is levied on the occupier puts him at a certain disadvantage There may be some considerable lapse of time before he can demand a revision of the terms on which he holds the property, and until this is possible he has to pay the tax unless he can shift it forward on to consumers In any case (and the point is particularly evident at the present time) the extreme difficulty of finding any other accommodation may make it practically impossible for him to move while even if other accommodation is available the cost of a removal (especially where it may involve the loss of a business or professional connection) may weaken the position of the occupier In the course of time the

general economic tendencies will probably work them selves out, but it may be an extremely slow and irregular process

All these statements hold both of general and local taxes There are however, some special points to be made in connection with local taxation The great dif ference between a local and national tax is that in the case of the former it may be easier to move out of the area affected by the tax To evade the English Income Tax one has to remove both oneself and one's invest ments into another country but to evade a specially high local tax one may, if one is taxed as an occupier and lives near the edge of the district only have to move house to a place a *few miles* distant Where the rates are particularly high in one district this tends to weigh most heavily against the taxpayers who are least able to remove themselves or their taxable property Thus if rates are twice as high in district A as in B few people (and none who are swayed by commercial considerations) will give the same rent for land in A as for that offering exactly the same facilities and involving only half the rates in B The position of the landowners in A as far as the differential rate is concerned will be weakened Further, in the case of new differential rates on building values the position of occupiers will be strengthened as compared with the owners for while they may be able to move out of the heavily rated area the existing build ings are immovable *As far as* new buildings are con cerned the differential rate probably tends to fall on the ground landlords for builders in A will know that they will have to compete for tenants and purchasers with builders in B, and as the building costs will presumably

be the same in both cases they can only do this if they can get their building sites on rather more favourable terms Unless the landowners submit to this the land will remain undeveloped To some extent the fact that the poorer workers are generally compelled to live near their work means that they may be less able to move than wealthier classes and less able to escape high rates

The whole problem of the incidence of local rates is a complicated one We may perhaps summarise the chief points as follows

1 The rates on site values tend to fall ultimately on ground landlords

2 The rates on building values tend to fall ultimately on consumers

3 In all cases the readjustment of rates probably works itself out slowly and the fact that the rates are imposed on occupiers in the first instance may mean that the occupier will bear the whole burden of new rates for some time

4 Where rates are higher in one district than another (especially than in a similar adjacent district) the position of the occupiers is stronger as far as the differential rate is concerned because of the possibility of moving out of reach of it

5 Ground landlords tend ultimately to bear the whole of differential rates

6 Where there is a great general shortage of building accommodation the position of occupiers is weak and they are likely to pay all increases in rates until the scarcity ends

§ 4 *Criticisms of the English System of Local Rates* Our system of local rating has been subject to severe criticism on grounds of equity The three classes most directly affected are owners of land, owners of other immovable property and occupiers of immovable property, although the last two classes may be able ultimately to shift part of the initial burden of the rates on to other classes It has been objected that the rates cause inequities between different districts, and between different individuals in the same district Landlords in heavily rated districts claim to be penalised as compared with those in other districts owners of immovable property claim to be penalised as compared with owners of movable property, and finally, occupiers of immovable property claim that the annual value of this is an entirely unfair basis for taxation

As far as the first two classes are concerned In dealing with the possibility of a special national tax on the value of land we argued that (although the tax had productive advantages) as it imposed a special tax on one kind of investment it might be criticised as an unfair differentiation against certain investors But where such a tax has been imposed for a long period the tax tends to be capitalised imposes no net burden on new purchasers of land and is a burden to which all holders of land (even if there has been no exchange by sale) have been accustomed for generations This point is important Rates in one form or another are an old charge on immovable property and where they have been in existence for some years probably do not constitute any net burden on the taxed property Old rates probably constitute no inequity between owners of

property in different districts, or owners of immovable and movable property

Another important distinction arises between rates which are *onerous* and rates which are *beneficial*. Much local expenditure is intended to react directly to the benefit of the taxing district. Expenditure on public parks, open places effective systems of sanitation or adequate street lighting yields a direct beneficial return to the residents in the district, and by increasing the advantages is likely to increase the value of immovable property in the district. As far as owners of property are concerned it does not seem unreasonable that they should be called upon to contribute to the expenditure in proportion to the value of the fixed property held. On the whole the value of this fixed property serves as a rough index of the advantages they are likely to receive from the improvements. As far as occupiers are concerned the case is less clear. It is true that one is probably justified in presuming that all occupiers will receive some benefits from greater conveniences and amenities in the districts in which they live, but it is not reasonable to suppose that the benefits they receive will vary in proportion to the annual value of the fixed property they hold. Nor of course is one justified in assuming that the annual value of their fixed property is an index of the ability of the taxpayers to contribute to the rates. It is probably broadly true that a man occupying a larger house is usually better off than a man occupying a smaller house but he *may* be compelled to occupy the large house because of a large family and there is certainly no reason to think that taxpaying ability varies in propor

tion to the rent paid The most that can be said for the system on grounds of equity is that it affords some rough compromise between the two ideas of paying according to benefits received (occupiers probably benefit from local expenditure) and paying according to the taxpaying ability (the heaviest payments probably fall on the wealthiest)

As far as new onerous rates are concerned the system is open to attack both from the point of view of the owners as well as the holders of fixed property Rates may be raised for essential expenditure and yet not be expected to show a direct return to the district The chief onerous rates are the *Poor Rate* (the oldest of all the rates) and the *Education Rate* which although it constitutes undoubtedly productive expenditure from the point of view of society as a whole cannot be expected to benefit owners of property in any way in proportion to the value of their fixed property within the district

The argument that rates on fixed property are necessarily inequitable must be qualified in the case of old rates and in the case of beneficial rates In the case of new or increased onerous rates there is undoubtedly a real differential burden on certain kinds of property (which affects both the owners and occupiers) and which is greatest in the districts (normally the poorest) in which the onerous rates increase most rapidly

§ 5 *Possible Alternative Methods of obtaining Local Revenue* Particularly where new onerous rates are concerned the existing system is open to criticism on equitable grounds but it is difficult to suggest an

alternative method of getting local revenue which would be even approximately equally economical There can be no doubt that to shift the burden entirely on to the central government would lead either to considerable waste through the local authorities spending money for the raising of which they were not directly responsible or else to the sacrifice of a considerable degree of local autonomy to centralised control A local income tax is difficult to assess and to collect In what proportions could such a tax be distributed between the district or districts in which an income was earned and the districts in which it might be spent? The problem of "double taxation" is becoming acute for national income taxes and would be far more difficult in the case of local taxes Experience has shown the extraordinary difficulty of making a local tax upon movable property effective The practice of some European countries of raising local revenue by imposing duties on goods coming into the taxing districts is not only extremely expensive to collect and easy to evade but is a hindrance and handicap on trade

Two suggestions for obtaining local revenue in rather different ways may be noticed in this connection

1 The undertakings of local governments can sometimes distribute their costs on the ordinary commercial principle of charging for value received Where gas, trams and electricity are supplied by local authorities the services are usually charged for in proportion to the value supplied to individual consumers at a rate high enough to cover costs Practically the need for each undertaking to cover its own costs has proved a considerable incentive to economy and efficiency in working

It has been suggested that these undertakings might be charged for in such a way as to clear a profit and this profit might be used for the relief of rates In Austria and some other countries important local revenues have been raised in this way In some cases the system might not be impracticable in this country but it is doubtful whether many of the existing services could yield a substantial surplus Wherever the plan was adopted consumers of certain kinds of municipal services would be penalised by having to pay in addition to the full cost of the service a tax to the municipality The case would be analogous to an indirect tax on say tramway services or gas with the advantage that it could be cheaply collected The chief argument against the scheme at present is that the services supplied by municipalities are not usually suitable for taxation A tax on tramways for instance, would hit the class who use trams and miss the class who use motor cars it would probably hit wage and salary earners, who often have to use the trams regularly most heavily, and by increasing the cost of transport might have some effect in increasing overcrowding in the centre of towns

2 A suggestion that has obtained considerable popularity is that a special additional local tax should be imposed on site values i e on the value which any piece of land has apart from any structure on or in it This calls for little additional comment It is claimed that it would not have the effect in checking the development of improvements that a rate on building values may have while as owners of land on the whole gain in a more permanent way from local expenditure than other ratepayers they would have no just complaint

that they were being unfairly treated If the second statement were qualified in respect to onerous rates both claims seem just Further, it is probably true that the separate rating of land values and the direct imposition of the rate on the owners would provent some friction and some hardship to occupiers On the whole the special taxation of land values might prove a useful subsidiary source of local revenue although it must be remembered that the national attempt to tax land values was found difficult and costly of administration

§ 6 *The Development of the System of Grants in Aid* The inequities caused by increasing burdens of onerous rates, and the failures of all efforts to alter the existing basis of local rating have resulted in a strong tendency to shift at least a part of the cost of locally administered services from the shoulders of the local authorities to the shoulders of the central taxing authority Large sums are distributed annually from the central exchequer in the form of grants in aid to the local authorities These grants have practically all developed during the last hundred years Up till 1870 they developed slowly, various grants being given for specific purposes without any fixed principle being apparent From 1870–1880 the outcry of the local taxpayers increased in volume, for while the period of agricultural depression drew attention to the agricultural rates, the urban expenditure on such services as water supplies was forcing up urban rates and the education rates after 1870 were a new and general burden on all districts In 1888 Lord Goschen attempted to limit the encroachments on the central exchequer by earmarking certain taxes (certain license

duties and half the probate duty) for local purposes—intending the grants to be limited to the yield of these taxes What he really wanted to do was to give the local authorities a fixed allowance beyond which they were to expect no more help but the Education Act of 1891 and the great increases in the cost of education since that date, the increasing cost of roads which with the development of motoring are becoming more and more a national question and the increase in other expenditure, have led both to the development of large additional grants, and to the transference of certain kinds of onerous expenditure from the local to the central authorities Old Age Pensions and Unemployment Insurance for instance both of which are financed and administered by the Central Government, have undoubtedly done something to relieve the local Poor Rates

As the relationship of Central to Local Finance at present stands its chief feature is its complexity Relief is given in all kinds of ways It is given for specific forms of expenditure (e g police, education etc) and is given on all kinds of principles It is still given from earmarked taxes and allotted between different districts on principles which have always been unfair and are now simply ridiculous and, finally, general relief is given to certain districts (e g agricultural districts) which are considered to need special help

The two problems that present themselves seem to be —

1 Should grants be given at all ?
2 If they are given on what principles should they be based ?

I

§ 7 *The Advantages and the Dangers of Grants in Aid*

1 As far as the first question is concerned the answer seems to be that as long as our present system of local rating continues some subsidies are inevitable unless serious injustice is to be done to the ratepayers, more especially in the poorest districts where the onerous rates are heaviest and the rateable value is often least Further many services undertaken by local authorities are definitely of the greatest national importance, in some cases they are left to the local authorities simply from motives of practical convenience, and it is essential that the national authorities should pay some attention to the efficiency of the services provided The country as a whole cannot allow the sanitary and housing arrangements of one town to become a breeding place of disease nor the main roads in one district to become a serious hindrance to transport nor the police in one area to be so inefficient that it becomes a resort and refuge of criminals nor should the children of one borough or county be penalised because the local governing authorities are slack in providing the necessary educational facilities

The system of grants in aid has the double advantage of equalising the burdens of different districts (it should be clear that rates for beneficial expenditure cannot be regarded as *net burdens*) and of giving the Government an opportunity to put effective pressure on local authorities who do not seem to reach the necessary standard of efficiency On the other hand, the dangers are that the grants encourage extravagance and destroy local initiative

2 The problem of the principles on which the grants

should be allocated bristles with difficulties We noticed Lord Goschen s attempt in 1888 to limit the demands on the taxpayer and to encourage local economy by giving certain assigned revenues to the Local Authorities This system had the advantage of being definite, but it gave the State no opportunity to vary the grants either with the varying needs of the districts or the varying needs of the services and it is worth noticing that it was allocated among the districts on a basis which Lord Goschen himself characterised as offending every known principle of Justice The system was entirely inelastic and had to be supplemented in view of changing conditions Up to 1913–14 many fixed or *per capita* grants were given on behalf of specific services The present tendency seems to be to give percentage grants to local services the State bearing a percentage of the total cost whatever that may be The vice of the percentage grant system is that the local authority which alone can really practise economy in these services, loses much of its incentive to reduce expenditure The deciding voice as to what money shall be spent is not that of the Government or the House of Commons but that of the local authorities The Departments are thus in great difficulties in framing estimates for these are based not on anticipations of what the department itself will do, but of what hundreds of local authorities may do The weakness of divided responsibility is manifest throughout

"If the Government were to attempt to impose a real and effective check from the point of view of efficient administration as well as audit, it would result in an enormous increase in bureaucratic control This

would tend to overload the central machine diminish local responsibility and lead to greatly enhanced administrative cost"

These criticisms of the Committee on National Expenditure seem on the whole to have considerable foundation, although there is perhaps too ready an assumption that all increased expenditure on education, public health or housing necessarily implies extravagance But even when it is admitted that it is extremely desirable that these services should be developed there seems reason for believing that where a high percentage of cost is borne by the Government administrative slackness may creep in and new expenditure may be too lightly undertaken Probably the recommendation of the committee that fixed grants should generally be given is on the whole sound Even so the problem is difficult The basis on which the grants should be fixed will vary from case to case Not only the needs of the ratepayers but the value and efficiency of the service have to be considered, and while it is clear that the Government cannot encourage extravagance in the use of funds it is equally undesirable that it should encourage the parsimony of some local authorities with regard to many services—more especially perhaps the educational and public health services At the present time the whole question of the relationship of National and Local Finance demands revision and simplification

CHAPTER VIII

WAR FINANCE

§ 1 *Fluctuating Prices Taxation and Borrowing* The period from 1914 has been a period of sensational fluctuations of world prices Both rising and falling prices react upon public finance Rising prices mean that the Government like every other purchaser finds the cost of obtaining goods and services increasing and the expense of carrying out its duties grows as prices rise Where rising prices mean increasing money incomes (and any considerable increase does normally mean this) there is some compensation both to the exchequer and the taxpayer The same rates of tax will yield larger revenues the money is worth less to the individual as well as to the State, and although the absolute amount paid in taxation is larger, the proportion of the national income absorbed by taxation is not necessarily increased

During the war period Government expenditure was increased not only by rising prices but by the innumerable new expenses which were forced on the State by the exigencies of war, and revenue had to be increased far more than in proportion to the rising prices No Government met all these expenses by taxation In some countries inconvertible paper notes were printed and used to meet part of the Government's charges

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Practically all countries obtained part of their revenue by loans In some cases it was possible for the belligerent countries to borrow abroad, and foreign debts were accumulated To a greater extent the loans were raised within the borrowing countries—internal debts were accumulated

Borrowing in war time, especially when repeated loans are needed is generally borrowing on an unfavourable market for the demand for capital is unusually great while the credit of a belligerent country is not at its best To some extent patriotic motives may offset these influences and lead individuals to invest in war loans but on the whole experience seems to have shewn that patriotism, unless backed by high interest rates, is not sufficient to attract subscriptions of the necessary size Apart from the interest rates the high prices meant that the loans necessary to meet any given expenditure were greater than they would have been had prices remained unchanged—the Government had to borrow more in terms of money because the value of the money was low

§ 2 *Rising Prices and Foreign Debts* The soaring prices during the war brought great evils in their train Rising prices generally affect profits favourably (for selling prices increase and expenses take some time to readjust themselves) and in this there is some gain to the Exchequer, both because incomes from profits normally contribute more largely to revenue than other incomes, and because such increases in profits are generally a stimulus to increased trade activity and to a further increase of taxable wealth The increase in profits, however, is gained at the expense of the other

incomes which do not automatically adjust themselves to price changes During the war wages lagged behind prices, and demands for higher wages caused incessant social friction Other incomes adjusted themselves even more slowly, while some fixed incomes could not adjust themselves at all The price changes led in effect to a considerable redistribution of real income, and this re distribution could not be justified on any principle of social justice The instability of values gave an element of instability to all contracts It was impossible for the Government or for anyone else to make any reliable estimate of expenditure over any considerable period of time This uncertainty made all trading speculative and helped to sow the seeds of the industrial collapse which began in 1920

Apart from internal difficulties violent changes in the price levels of any country are bound to affect the value of its currency in terms of the currency of other countries To some extent this result was hidden during the war by emergency measures but after the Armistice it became abundantly clear England found that her currency had depreciated in terms of that of her chief creditor, America (at one time the £ sterling was worth only 15s in New York) and as America had maintained the gold standard this represented approximately the depreciation of the £ in gold The other European belligerents were in a worse plight Their currencies were much more depreciated and in such extreme cases as Russia and Austria had become practically worthless for foreign payments Apart from the difficulties to which this led in ordinary trading, it meant a great complication in the public revenues of all countries

with payments to make abroad on behalf of Government indebtedness and in the worst cases made the financial position practically hopeless

Each country has to raise its revenue in terms of its own currency If it has payments to make to other countries which are fixed in terms of their currency or in terms of gold, depreciation means that an increasing amount of depreciated currency will be needed to make the payments Where prices within the country have changed in proportion to the depreciation of the currency there is no real hardship in this If England had had to repay her American debt when the £ was worth 15s in New York she would probably have had to raise more pounds to repay her debt than she received when the loan was made but as her prices had readjusted themselves the £ would be worth less to her as well as to America If however depreciation is still continuing to such an extent that dealings in the depreciated currency have become little more than a chaotic speculation there may be violent fluctuations in the value of the currency in terms of foreign currencies, while there is no immediate corresponding change in prices at home In a case of this kind where large payments have to be made abroad the business of balancing the budget is practically hopeless

Germany is probably the extreme example of this, and it is worth glancing at the difficulties of her position She is committed to heavy payments for reparation to the Allied Governments These payments are fixed in terms of gold marks In the summer of 1921 the gold mark was worth about twenty paper marks By the end of the year its value was fluctuating between forty five

and sixty five paper marks This meant that to meet the same payments in gold the German revenue would have to be nearly trebled in terms of their currency The fluctuations in the currency were not attended by any thing like a corresponding change in prices or in money incomes in Germany, and the increased burden of the heavier taxation would be enormous Even if prices did readjust themselves it could only be done at the cost of much social suffering and discontent, while even so it must inevitably take some time for the necessary alterations in the tax assessments to be made The attempts of any finance minister to balance a budget in these circumstances seem necessarily doomed to failure

§ 3 *Falling Prices and Internal Debts* Given these possibilities it is not surprising that public opinion and economic teaching were at one at the end of the war in advocating a check to further rises of price and a stabilisation of the exchange values of currency in the countries which had not already plunged too far into the slough of depreciation Here another difficulty arose To check the rise meant in most countries a necessary fall in price for the high prices were maintained partly in the expectation of further rises From the point of view of the Treasury falling prices have serious disadvantages They reduce money incomes and by doing this reduce the taxable capacity of the country as measured in terms of money They reduce profits first and by doing so reduce first the incomes which yield most to the revenue Further, as falling prices are a cause of trade depression, reducing output tends to reduce the real taxable capacity of the country

If the payments that the Government had to make depended entirely on current prices these results would not be important In fact, as there is some lag between the beginning of the fall in prices and the fall in the yield of taxes, there might even be a temporary gain to the revenue But where the Government has liabilities fixed in terms of the currency of its own country, falling prices cannot reduce this part of its expenses At the present time falling prices in England may by pushing up the value of the £ sterling in terms of dollars, reduce the payments in terms of our money that we shall have to make to the U S A Further, as prices fall some of the Government's home expenses—salaries of all kinds for instance—are being correspondingly reduced But as far as our enormous internal debt is concerned no automatic reduction can be hoped for The debt was fixed in terms of money and interest has to be paid at a fixed rate until other arrangements can be made or the debt repaid at par A holder of a £100 nominal of 5 per cent War Stock has the right to £5 a year, whether the £5 will buy little or much The purchaser of £77 10s War Savings Certificates in 1918 has the right to £100 at the end of five years, whatever the £ may be worth in 1923 Where a debt has been accumulated on these terms, steadily falling prices mean that an increasing proportion of the money income of the nation is needed to meet the interest and ultimate repayment of the debt As prices fall the purchasing power of each unit of money increases and the real sacrifice involved in making the same money payment increases Austria and Germany have suffered enormous hardship from their depreciated currencies but they have reaped one advantage in that

they have steadily reduced the real burden of their internal debts As the value of a currency falls the fact that a Government is committed to heavy annual payments in terms of that currency becomes less and less important, and the real burden to the taxpayers of the necessary taxation steadily decreases

The position of the belligerent Governments at the end of the war was not a comfortable one On the one hand they were faced with an urgent economic need to check the rise in prices, on the other with the danger that falling prices would increase the real burden of the heavy internal debts

§ 4 *What Government Borrowing Means* The conclusion would seem to be that it is always extravagant for a Government to accumulate debts in a period of high prices which may have to be repaid and on which interest may have to be found, in a period of lower prices The money borrowed and the money to be repaid may be the same in both cases but in the latter the value of the money will be greater than in the former, the value repaid will be greater than the value received

It is generally recognised that neither Governments nor individuals can hope to remain solvent if they borrow for ordinary recurring expenditure In the case of an individual or a company however, it is not considered necessarily inconsistent with sound finance to raise a loan in a period of exceptional emergency to be repaid when the emergency is over Government borrowing in times of war has generally been justified on the same grounds

The position of the Government differs fundamentally

from that of the individual The individual borrower really draws resources from some one else and postpones *repayment* to a future date He makes no immediate contribution himself and thus avoids the immediate burden of payment If a Government borrows from abroad the borrowing country is in the same position Other countries lend it resources and it postpones repayment to a future date If however a Government borrows from its own nationals (and the bulk of Government borrowing comes from this source) it draws resources from them just as much as if it taxed them Whether the Government raises revenue by taxation or by an internal loan the only resources upon which it can draw are the same and the borrowing country cannot avoid the immediate burden of finding the necessary funds The only difference is that where the money is raised by taxation it is paid over finally to the Government where it is raised by borrowing there is a claim for interest and ultimate repayment on the part of the lenders From the point of view of individuals however taxation and borrowing do not mean exactly the same thing Borrowing gives the individual a future claim on the Government which taxation does not and the war loan stock (or whatever other security he may hold) can be used for raising funds at any time Also although the taxpayers as a whole will ultimately have to find the money to meet interest and repayment it is improbable that the individual taxpayer will find that his increased taxation (due to interest on debt) exactly cancels out his income from war stock, and it is still more improbable that he will set the two against one another in considering his gains from subscriptions to

war loans From the point of view of the Government this has the real advantage that resources will be lent with less ill feeling than they would be paid in taxation and it means that the immediate subjective burden of the tax to the country is less than if the money had been raised by taxation In the first instance this probably means less discouragement to production than equal taxation Where enormous war revenues have to be raised for a term of years it is possible that to raise the whole by taxation would have a deadening effect upon incentive and in any great war a Government may be justified in raising a part of its revenue by loans It should however be realised that by means of borrowing the Government does not avoid finding the immediate resources that it needs it only adopts a different method of obtaining them

§ 5 *Different Methods of Borrowing* Enormously the greatest part of our National Debt has been incurred to meet war expenditure The Government holds no assets against it and the funds for interest and repayment have to come out of taxation Deadweight debt of this kind is generally divided into two classes—funded or consolidated and unfunded or unconsolidated or floating debt The former is composed of permanent debt (which is not repayable at any fixed date) and long dated securities The latter is the result of short period borrowing and is repayable at a fixed date at the end of a few weeks or at most at the end of a few years The distinction between funded and unfunded debt is not drawn in precisely the same way in all countries In some obligations

maturing after 3 4 or 5 years are regarded as part of the unfunded debt, in others (as in England) only that part of the debt which gives a claim to repayment within 12 months of the date of issue is classed as unfunded

Before the war nearly seven eighths of our dead weight debt consisted of permanent debt This debt had been incurred at various periods mainly during the nineteenth century wars but the various securities of which it had originally consisted had by 1914 been nearly all squeezed together into one big lump the Consolidated Debt, more usually known as Consols This debt carried interest at $2\frac{1}{2}$ per cent A small part (something like 3 per cent) of the permanent debt had not been included in this consolidation and carried interest at $2\frac{3}{4}$ per cent

The unfunded or floating debt was at that time an insignificant part of our total liabilities, and was incurred mainly in anticipation of revenue which was expected to fall in later in the year A very small part of the debt was held permanently in the form of Treasury Bills as the most convenient form of investment

The other item in our deadweight debt was the capital liability of the Government on behalf of terminable annuities In some cases fixed sums had been paid down to the Exchequer in return for which the Government undertook to pay annuities This was essentially a method of repaying debt, not of borrowing and need not detain us further

From 1914 onward the great financial needs of the Government made it eager to tap all possible sources of revenue Long date war loans, war savings certificates

short dated Exchequer Bonds and 3 month and 6 month Treasury Bills were issued to meet the needs of all classes of investors The loans were backed by every kind of patriotic appeal Posters propaganda, tank weeks, as well as the merits of the loans themselves were all used to catch subscriptions for the Government net

§ 6 *Borrowing and Inflation* The investments came from different sources In part they were subscribed by private individuals who put their savings into war loan in preference to other investments or who perhaps cut down their normal expenditure in order to increase their war time savings Where this happened resources were transferred from the lenders to the State just as much as if the transference had been made through taxation The Government was able to buy more the spending power of the lenders was correspondingly reduced and the total volume of purchasing power in the country remained the same

A large part of the subscriptions to the different loans did not come from individuals but from banks In this case it was not so clear that the increased saving really represented a transference of purchasing power, and increased economy on the part of the lenders Banks cannot increase the supply of money by increased issues of notes or coins but they can increase the supply of credit by giving increased power to draw cheques against them, and this is equivalent in its effect on prices to an increase in the supply of money When either governments or individuals borrow from banks there is a possibility that purchasing power will not be transferred, but that new purchasing power will be created If the

banks had given credit to the Government by restricting the credit they were giving to business men there would have been no net increase but as it was, the increased credit was far in excess of the pre war credit issues of the banks There can be no doubt that the banks sub scriptions to war loans largely represented new issues of credit

Where individuals borrowed from their banks and lent to the Government the result was the same as if the Government borrowed direct from the banks

Certain kinds of government borrowing carried this business of increasing credit even further The Govern ment could borrow from the Bank of England by what were known as Ways and Means Advances, a form of borrowing which in pre war days was used only to a limited extent and only for very short period advances To take an instance of how this borrowing worked If the Government borrowed one million pounds from the Bank the Government's credit would be increased by this amount, until it drew a cheque against it and paid it out to some creditor This creditor would presumably pay it into his own bank The Government's credit at the Bank of England would be decreased, but the creditor would have a right to draw a cheque on his bank, and his bank on the Bank of England for a corresponding amount There would be a net increase of one million pounds in the purchasing power of the country But the matter would not end here! It is the tradition of English banking that a credit at the Bank of England is regarded as cash The bank which had a claim on the Bank of England for one million pounds (although its liabilities to its client were in

creased by a corresponding amount) would find its reserve strengthened in proportion to its liabilities, and this might be used as the basis for a further extension of credit, which in its turn would probably be lent to the Government The original one million pounds loan might thus mean an ultimate extension of credit considerably in excess of its original amount and would have the result of pushing up prices and increasing in this way the expenses of government

Borrowing of another kind—borrowing by means of treasury bills—had a somewhat similar effect These bills matured so rapidly that they could practically be regarded as a cash reserve and by strengthening the reserve increased the bank s credit issues The increased spending power was always likely to come back to the Government either through taxation or new borrowing

An objection that seems to arise here is that even although the banks could create credit in pre war days, an effective check was imposed by the necessity of maintaining a cash reserve and the bank s credit issues were kept within bounds Certain cheques would be presented for payment in cash, and a proportionate reserve had to be kept to meet them If prices rose from any cause the result was that as wages and other out of pocket expenses rose, increased demands for cash to meet these higher charges would be made on the banks, and as a result these—finding their reserves imperilled—were compelled to check their credit increases The reason that this check did not operate effectively during the war was that Treasury Notes had been issued by the Government and made legal tender Although these

could not be manufactured by the banks, they could be obtained by practically any bank with claims on the Government or the Bank of England, and the Government borrowing was continually making these claims In consequence the old check operating through the necessary minimum cash reserve was removed

The English Government did not print off inconvertible notes to pay directly to those to whom it was indebted This has generally been counted to it for righteousness It should, however, be realised that the issue of Treasury Notes (which were in theory convertible and in practice inconvertible) and the possibility of the banks obtaining supplies of these notes, were an essential condition of the bank loans out of which the Government financed a large part of its undertakings Both methods increased the supplies of purchasing power, and the result in inflating prices was probably much the same While part of the evils of post war finance arose out of the fact that debts had been accumulated while prices were high, the higher prices were in themselves to some extent a result of the Government borrowing It must, however, be clearly stated that higher prices between 1914–20 cannot, in any case, be entirely ascribed to the finance of any one government World prices were rising, in neutral countries in which the gold standard was retained prices rose as well as in the belligerent states, and while the policy of any government which increased purchasing power was a contributory factor the most rigid avoidance of inflation would not have kept its price level stable although it would have avoided the difficulties which resulted from the depreciation of its currency in terms of other currencies

§ 7 *The Cost of Inflation* When governments borrow from individuals who meet the loans out of genuine savings or where they obtain revenue by taxation, it is clear that individuals are poorer as an immediate result of the Government's command over increased purchasing power Where new purchasing power is created there is no transference no one is asked to surrender what the Government gains, and at first sight it might seem a painless solution of the problem This is obviously untrue The new purchasing power is not taken away from private individuals but its existence raises prices and a rise in prices reduces the values of all incomes If prices are doubled this means that the same incomes will only go half as far as before and the result is exactly the same as if all incomes were reduced by half, prices remaining unchanged Where the Government gets its funds by methods which raise prices the result is really a hidden tax proportioned to income which works not by reducing the *amount* of purchasing power in the hands of individuals, but by reducing its value

In all our overt taxation we have been moving away from the idea of a tax proportioned to income (and this form of concealed taxation does not allow even a minimum for necessaries nor does it make any allowance for differences in family needs), and there seems no reason to regard it as anything but thoroughly inequitable by our existing standards It is true that considerable readjustments may be made Wages for instance, will gradually rise to meet the higher cost of living and the increased supply of purchasing power will gradually be distributed among different classes, but the readjust

ment will only take place slowly and as we have already said, as the result of considerable friction Further, to many classes there will be no possibility of readjustment People with fixed incomes will find themselves permanently impoverished unless prices return to their old level There will be a considerable transference of real wealth from them to other classes, and the extremely arbitrary nature of the readjustments puts them out of reach of any defence in the plea of improving distribution Further although the effect of the inflation is the same as a tax in that it reduces the real incomes of individuals without giving them a claim for repayment, from the point of view of the Government it is a loan for which interest has to be found and a capital repayment made The only purchasing power over which Government obtained control without incurring interest charges were the Treasury Notes In all other cases whether borrowing was done by Treasury Bills, Ways and Means Advances or by more permanent loans, interest had to be met and the capital ultimately repaid Where the loans simply represented increases in bank credit the country suffered immediately from the inflation for the future the taxpayers had the bill for interest and repayment while the banks reaped hand some payments for collecting what was in effect "a forced levy from the public on behalf of the Government"

On the other hand, there is no doubt that the methods of borrowing from the banks have immediate conveniences to any government and were a very real convenience to the English Government during the war

Borrowing by Ways and Means Advances or by

Treasury Bills was less obvious and therefore less likely to meet with criticism particularly as it could be done without inconvenience to the lenders Where a government was eager to keep down the rates of interest on loans and it was feared that too high a rate might injure the financial reputation of the borrowing country it was probably the only method which could be used In the early days of war before taxation could be readjusted or the machinery of more permanent loans to be taken up by the general public be set going some borrowing from the banks by these means was probably inevitable but the heavy price that must ultimately be paid in the friction of rising and falling prices the cost to the Government of rising prices in the time of its greatest need for services and goods and the heavy burden of debts accumulated in the periods of high prices being carried over into the period of falling prices, are strong arguments for the stringent limitation of its use

One last point may be noticed here Floating debts repayable at short periods may always fall due at times inconvenient to the Government and entail further borrowing on less favourable terms The maturing of short dated loans of any kind may be a serious handicap to a government struggling with the problems of post war finance and may force further borrowing and possibly further inflation

CHAPTER IX

THE POST WAR BURDEN OF DEBT

PART I INTERNATIONAL DEBTS

§ 1 *The Growth of International Indebtedness* Wars have nearly always increased the national debts of the belligerent states The Great War left the world in a state of indebtedness which is unparalleled both as regards the absolute size of the Government obligations and the extraordinary complexity of the international arrangements

Taking the international problem first During the war years the greater part of the international debts arose out of loans between the allied states After the Peace a new factor was added by the obligations imposed on Germany by the Treaty of Versailles which have since been subjected to modification and which still have probably not taken their final form As the position at present stands on paper America has enormous claims on this country and on all the European Allies amounting in all to some $11 000 m England has her debts to the U S A and some other smaller obligations amounting to about £1200 m , or just about twice the total of her pre war National Debt She has large claims on the European Allies for War Advances (more especially on Russia, France and Italy), and a considerable claim on Germany Her external obliga

tions (even after allowing foi the defalcation of Russia her largest individual debtor and apart from her claime on Germany) are more than offset by the debts owed to her from abroad France Italy and Belgium are faced with their liabilities to England and the U S A against which they and more especially France have large claims on Germany, while Italy has some rather shadowy claims on Austria This is of course not a complete account, but it gives some idea of the complexity of the position

In practice although the debts stand the obligations they imply have not been stringently enforced between the Allies Interest payments have been deferred and the actual difficulties of making these payments have not yet been felt Although measures have been taken to exact some reparation from Germany even here modifications of the original demands have been admitted the existing claims have not been exacted in full and it is debatable whether this ever can or will be done

From 1919–1922 European finance has been over shadowed by the enormous international debts The claims they imply have been a menace rathei than an active evil but the uncertainty as to whether, and to what extent they will be collected adds to the existing confusion The tendency to regard claims as definite assets and liabilities as a fiction that can be disregarded or at worst as a problem of a very distant to morrow makes it possible for some countries to postpone the measures that are necessary to meet the realities of the position In all cases until a permanent settlement which is both definite and practicable can be reached

the public finances of the different states cannot be put on a more permanent footing, nor can the exchanges be expected to reach anything like a stable position. The full evil of this uncertainty cannot be over emphasised. Trade can in time adapt itself to most conditions. The real difficulty of the present period is that as the conditions are continually changing no chance of adaptation can occur.

§ 2 *Repayments and the Debtor Countries.* A country borrowing abroad escapes the immediate burden of raising the necessary revenue. When the time for repayment comes the deferred responsibility has to be met and provision made to meet interest charges and gradual repayment of the capital liability. Part of the income of the debtor has to be transferred to the creditor country and the former is poorer by the amount of the transference.

To make payments abroad a country has to raise revenue just as much as for any other payment and has to use the revenue to obtain claims on gold or on the currency of the creditor country. She can obtain the necessary revenue either by taxation, borrowing or further inflation. Whichever of these methods she adopts means that, in one way or another, the real incomes of her nationals are immediately reduced, and where as a result of this, productivity is checked (and as the revenue is to be transferred abroad it is clear that there cannot be any direct economic compensation for the taxation) it means further impoverishment of the country. The evils of an addition to revenue made necessary on behalf of foreign debt are greater the greater

the impoverishment of the paying country and the heavier its existing burdens

At any time it is extremely difficult to say how far a country can bear further taxation But it is a question of fact that at the present time all the European belligerents are finding the greatest difficulty in balancing their budgets and many of them are still obtaining revenue by borrowing or inflation—mainly the latter Even if it may seem that this result is partly due to slovenly finance and if in theory, new openings for taxation may be found it is always true that a country cannot outstrip its administrative financial machinery and the fact that its taxation in the past has been badly organised may be a great practical difficulty in the way of raising more revenue in the immediate future Where a country has used inflation to meet existing difficulties, an addition to her responsibilities is likely to lead directly and indirectly to further inflation further rises of internal prices and further fluctuations of the value of the currency on the foreign exchanges We referred in the previous chapter to the difficulties in which fluctuating exchange rates may involve a country with payments to make abroad but the point is worth emphasising that the greatest hardship from further inflation is likely to fall on the poorer classes of the debtor countries and is likely permanently to reduce their standard of living A claim for millions between nations may in the paying country resolve itself into exacting sums from individuals to whom the payments mean the difference between poverty and destitution

§ 3 *Repayments and the Creditor Countries* A country

with claims on a foreign country is entitled to a net addition to her national income of the amount of her annual claims over and above her own annual production On the face of it this seems a desirable position but at the present time some creditor countries seem to be suffering from considerable doubts as to whether they can afford to be paid! To make the payments the debtor country has to get hold of credits in the creditor country The only way in which she can do this is by selling abroad and by using the credits which she gains in this way not to buy goods from abroad (which would be the ordinary trading position), but to pay her debts

Now this is where the possibility of injury to the creditor country arises the ugly possibility that getting "something for nothing" in international finance may not be as agreeable as one would expect For the pushing of foreign sales and the check to foreign buying will react injuriously upon all countries that either sell to the paying country or compete with her in production On the one hand, competitive industries will find her competition developing and encroaching on their markets, on the other the selling industries will find her demands from them checked Where the financial position of the debtor country is so bad that her currency is depreciated and worth less abroad than it is at home, the invasion of foreign markets will be accelerated, for she will have in effect a bonus on her foreign sales Whatever the position of the currency of the country originally the fact that the debtor country has to make these payments (if they are on a large scale) is likely to make her currency cheap and to give her some bonus on exports

A concrete example may make these points clearer Germany has payments to make abroad on behalf of reparations In order to do this she has to get control of foreign credits which she can only obtain by pushing her sales abroad Owing to various circumstances, including her own financial difficulties, the extreme uncertainty of the future demands on her and the general instability of exchange rates the value of the mark in gold was much lower than the price level in Germany warranted even before the actual payments began This meant (to take an arbitrary example) that if it cost a German producer 80 marks to produce a commodity which would cost £1 to produce in England, the 80 marks would not be worth £1 on the foreign exchange but something less than that amount If a German producer had goods worth 80 marks in Germany to sell, he might sell them in England for, say, 18s, which would undersell the English producer (who on our hypothesis could not produce 80 marks' worth of German goods for less than 20s) and could sell his claim to 18s for sufficiently more than 80 marks to make a net profit on the transaction The expensiveness of sterling in terms of marks while helping Germany to sell would make it practically impossible for her to buy from abroad

Normally the position would right itself But where the German Government has got large payments to make, her demand for foreign currencies will keep up their value in marks, it will be to her interest to push her export trade wherever possible while internal financial difficulties are likely to prolong the policy of inflation which in its turn helps to keep the value

of the mark down The net result must be that she will sell more and buy less on foreign markets

It is important not to make the picture too black As consumers we shall gain from Germany s lower prices, and probably many of us have felt a guilty lifting of the heart as we have bought the cheaper German goods If Germany exported only raw materials which could not be produced in England we should gain as consumers and we should not lose directly as producers from German competition, although we might still suffer from her inability to buy from us As it is Germany's exports compete very largely with our own products, and in pre war days she was our most important European market The result is that this market is largely closed to us, and her invasion of our home and foreign markets is a cause contributing to unemployment and trade stagnation We might, of course protect our home markets by import duties against German goods but, apart from the general objections inherent in any schemes of this kind and the injustice and inconsistency of insisting upon payments and putting obstacles in the way of making them, we should still suffer from her competition with our producers in foreign markets Any general prohibition of her export trade by joint allied action would simply deprive her of the means of paying her debts We shall gain from the repayments if and when we get them but we may suffer considerable incidental trade dislocation through the methods of payment

Although the degree of competition will differ from case to case, the result of the payment of international debts must always lead to smaller purchases

and larger sales abroad on the part of the paying country

§ 4 *Pre War Debts* To these somewhat lugubrious pictures of the costliness of being paid what one is owed it may be objected that in pre war days England and other old countries had enormous foreign investments which although they were held by individuals and not by governments involved very considerable annual international settlements which were unattended by the disasters we have suggested This is true—but these payments differed in important particulars from the payment of interest on war debts

1 The foreign investments had been made mainly for productive purposes If Australia raised a loan in England for purposes of railway development she would have to make annual interest payments but she would expect the railway to give her large enough returns to do this and give her a profit on the undertaking as well Australia presumably would not be poorer than before because of the railway and its costs and the payments would not therefore necessarily reduce her power to buy from abroad

2 The development of investment abroad in pre war days was gradual Any slight stimulus that the exporting country gained developed slowly, and the competing countries could adjust their industrial organisation gradually It is essential to realise the importance of this At any one time a country is organised for a certain kind of production This organisation is always changing slowly as some industries develop and others decay and it is always capable of gradual readjustment But

any sudden disturbing factor means that a time must elapse before the organisation can adjust itself, and until this happens the country suffers all the troubles of dislocation, depression and unemployment Practically all countries are going through a period of dislocation as a result of the transition from war to peace conditions Where this is emphasised by a sudden change in the relative exporting and importing capacity of other countries through international payments on behalf of war debts the disturbance is likely to be considerable If the payments continue for a long period the industry of the receiving country will adjust itself Industries in which the new competition is not felt will be developed, the industries which find themselves undersold will gradually be abandoned When these adjustments have been made the full advantage will be drawn from the payments When the repayments are completed a further readjustment will be needed

The real problem in any case is whether the advantages to be gained are worth the disadvantages of the double readjustments The repayments will undoubtedly help to impoverish the paying country If that in itself is an object to be desired there can be no doubt that the rigid insistence upon repayments will help to achieve it If it were probable that steady payments would be made for a long period there can be no doubt that the real gains to the receiving countries would be considerable They would receive a steady addition to their net incomes and after the initial friction had worn off this would mean real gain

The larger the payments, the greater the initial friction is likely to be To incur this for payments which are

not likely to be continued, or continued only on a smaller scale, is doubtful wisdom Where it is possible that the payments may reduce the paying country to a state of economic poverty or political anarchy that will make their continuance impracticable, or where it is possible that a change of policy may lead to a modification of demands the chance of the ultimate gains to the receiving country outweighing the initial disturbance are not so great

If the paying country is just able to pay her debts but is permanently impoverished the receiving country will have to count as a permanent loss any part of the profit she had from trading with her debtor in more prosperous days—a consideration which is likely to have more important consequences for a commercial country such as England than for any other

PART II INTERNAL DEBTS

§ 5 *The Repayment of Internal Debt* The payment of interest on foreign debt reduces the net income of the paying country by transferring a part of its income abroad The payment of interest on an internal debt has no direct effect of this kind money is raised within the country and paid out to holders of Government stock also within the country The total national income of any one year is the same whether the £350 m a year which our internal debt costs us is left in the pockets of the taxpayers or taken from them and paid out as interest on war stock To a large extent it is simply an elaborate and expensive method of taking money out of one pocket and paying it back into another of the same individual

Although the payment of interest on war debt does not reduce the productive capacity of the country as a whole, the necessary taxation may have indirect effects in discouraging production We have seen how the expectation of heavy taxation (and the service of the internal debt accounts for nearly one half of our present taxation) may discourage production, and in this case there is no compensating gain to be set off against the discouragement The money is simply redistributed There is no presumption that holders of war stock will use it better or need it more than the taxpayers If anything the presumption is against the redistribution When the value of money is rising in a period of falling prices the real burden of the debt becomes heavier and the possibility of the discouragement of taxation increases The position of the holders of war loan improves at the expense of the taxpayers and an element of injustice creeps in

These disadvantages make the paying off of the debt desirable while there is the additional practical consideration that if the Government should need to borrow again, its credit is not likely to be improved if it has made no effort to reduce its earlier debts The real problem resolves itself into the question whether it is preferable to impose heavy taxation over a term of years to meet interest and a sinking fund for the gradual repayment of debt, or to impose an extraordinary levy to meet the emergency and pay off a part of the debt quickly

There is a third alternative The State might repudiate the whole or a part of its debts In this country the suggestion hardly enters into practical politics, and is usually condemned out of hand on the grounds that it

would involve a breach of faith on the part of the Government with the holders of all war stock Repudiation would certainly cause some great individual hardship and give a severe shock to the national credit, and may be regarded as definitely inexpedient

§ 6 *Sinking Fund Method* The traditional method of repaying debt has been to raise wherever possible an excess of revenue over current expenditure paying the balance into a sinking fund and using it to reduce the principal of the debt This implies that in the first instance the revenue raised must exceed that necessary for interest payment but as the principal decreases the annual debt charges will be gradually reduced In pre war days the repayment by the sinking fund method was always a slow business Sinking funds are easy to raid In any difficulty there is a temptation for a harassed chancellor to divert the funds that would otherwise be used for redemption of debt rather than to use the inevitably unpopular measure of further taxation Where taxation is so heavy that the available sources of taxation are exhausted it is extremely difficult to raise any substantial surplus A country that is heavily burdened by taxes can at most hope for very gradual reduction of its burdens by repayment of the principal of the debt by this method Although England in 1921–2 paid sums into her Sinking Fund for purposes of debt repayment the burden of taxation was found so heavy that the Sinking Fund was suspended in 1922

§ 7 *Conversion of Debt* In the past Government debts have been put on more favourable terms from the tax

payers point of view by processes of *Debt Conversion*. In the case of a permanent loan the Government is in the position of having undertaken to pay a fixed rate of interest until the debt is repaid at par, without having any obligation to make the repayment at any fixed date. If the current rate of interest falls so that no new investments offer as favourable terms as the Government stocks their value will rise. For instance, if the rate of interest fell so that long period loans could be raised for just under 4 per cent the market value of £100 nominal of war stock yielding 5 per cent would be likely to rise to at least £125. In these circumstances it might be possible for the Government to "convert" its debt by reducing the rate of interest to 4 per cent. The holders would be given the option of repayment at par so they would suffer no injustice; the Government would effect a substantial economy by reducing the interest rate on the converted debt by one fifth, and as the rate (4 per cent) would be above the market rate (which we said was slightly below 4 per cent for similar investments) it is improbable that the Government would be embarrassed by a large number of holders demanding repayment in preference to accepting the new terms. The last great conversion in the history of the English debt was that carried out by Lord Goschen in 1888, when the rate of interest on the then 3 per cent stock was reduced to $2\frac{3}{4}$ per cent until 1903, and to $2\frac{1}{2}$ per cent after that date. Of $592\frac{1}{2}$ million of 3 per cent stocks about $565\frac{1}{2}$ million were converted and the saving to the exchequer was a not insignificant percentage of the total expenditure at that date.

In the case of debt repayable at par at a fixed date

(and the bulk of our debt is now of this kind) the Government has an opportunity of reborrowing on more favourable terms whenever the debt falls due In the case of long dated securities this opportunity only occurs at the end of long periods In the case of short-dated securities holders may be willing to convert into long dated loans at more favourable rates from the tax payers' point of view Considerable economies of this kind are only likely to be possible if the financial policy of the government commands confidence, and if the interest rate has fallen since the original borrowing Conversion options to holders of short dated securities may be of some benefit to English taxpayers in the next few years but various considerations reduce the possibility of any very rapid decrease in our debt charges from debt conversion

1 The greater part of the debt is held on terms which preclude a reduction in the rate of interest for a term of years

2 Even if conversion became possible for a part of the debt the reduction of rate could only be gradual and it would be a long time before a reduction of more than a $\frac{1}{2}$ or at most 1 per cent could be hoped for

3 A reduction of rates on a permanent loan almost necessarily involves the guarantee of no further reduction for a period of years When Lord Goschen converted 3 per cent Consols the terms guaranteed the $2\frac{3}{4}$ per cent rate for fifteen and the $2\frac{1}{2}$ per cent rates for an additional twenty years so that although succeeding Governments reaped a substantial economy from the change they were pledged not to go beyond the defined terms for thirty five years Some such

guarantee is probably always essential to give the public confidence in the revised terms On the whole it seems useless to expect any very sudden sensational decreases in cost from this method

§ 8 *What the Postponement of Repayment Means* The traditional methods of repaying debt do not seem to promise more than a gradual reduction of cost and we have already referred to the disadvantages of this The burdens of the heavy recurring taxation may prove a handicap on economic development and may make it impossible for the State to undertake necessary productive expenditure Where prices are falling the arguments against the perpetuation of the debt are particularly strong The discouragement grows heavier, the falling prices are likely at least to offset the possible advantages to be hoped for from conversion and the war stock holding class gains steadily at the expense of the taxpayers The economic evils of enormous debts and very heavy taxation are sufficiently apparent But are the difficulties and disadvantages of immediate repayment any less?

The most popular argument against immediate repayment of war debt is probably that as the present generation bore so much of the cost of the war they are justified in leaving the burden of the repayment of war debts to posterity This might be true if it were possible But as far as the internal debt is concerned the generation which makes the loan finds the funds once and for all These are transferred from peace to war uses Posterity suffers because new capital investments will be curtailed and existing capital allowed to depreciate (at

present we are poorer because of the absence of the new houses, factories and machines which were not built, and the depreciation of the old which were neglected, during the war) but beyond this important incidental injury the burden is not and cannot be shifted on to posterity In the case of a tax, the matter is ended when the tax is paid In the case of a loan, interest is paid by succeeding generations but they pay it to stock holders of the same generation The same is true of repayment If we repay our debt now we repay it to ourselves If we leave it to 1942 or 2042 taxpayers in those years will pay stock holders in those years and taxpayers in all the intervening years will presumably pay those with claims to interest in those years But what posterity pays it will pay to itself, and we cannot make it bear any of our burdens The only question is whether the disadvantages of continual redistribution through taxation interest payments and gradual repayment are less than the disadvantages of one great upheaval and one great redistribution

§ 9 *The Advantages of Immediate Repayment* The main advantages of a special levy to repay debt seem to be

1 That as the levy would be imposed for a special purpose and would be definitely intended not to recur any bad effect that the expectation of it might have in reducing production would be limited in time and the reduction of taxation in the future would reduce its possible bad effects on the incentives to production The heavier the annual taxation the greater the advantages of a reduction would be and a much stronger case for an immediate exceptional effort to repay debt exists

when the annual taxation (in the absence of exceptional effort) is heavy than when it is only moderate as compared with the total income of the country

2 Where a fall of price is expected the case for immediate redemption is exceptionally strong, for without it the burden of debt increases and the holders of Government securities gain at the expense of the tax paying community If a rise in prices were expected immediate repayment would be less to the taxpayers interest, for the future fall in the value of money would automatically reduce their burden at the expense of the holders of the Government securities

The two forms of special levy that have been suggested have been a special levy on all accumulated wealth and a special levy on wealth accumulated during the war On the whole, although annual taxation is probably most satisfactorily based upon annual income, a man's ability to contribute to one special levy depends upon his total resources rather than upon his income at the date at which the levy is imposed, and total resources are probably practically best measured by accumulated wealth

§ 10 *A Levy on Capital* The proposal to impose a general capital levy has been condemned as inequitable impracticable, and likely to inflict a fatal blow on our industrial prosperity It is perhaps important to point out that to answer these charges for practical purposes, supporters of the levy have to show not that it is perfectly equitable, capable of perfect administration or without any injurious economic results, but only that on the whole its effects are less bad than those of recurring annual taxation

As far as equity is concerned the existing system seems in itself to present so many injustices that it hardly becomes those who oppose an alteration to lay too much emphasis upon the aspect of fairness The accumulation of the debt itself was open to criticism When people who were able to fight were called upon to make the most complete personal sacrifices with the minimum of pecuniary compensation, the fact that people who were able to lend should have been entitled to the very favourable terms they got for their loans may have been expedient, but will hardly bear strict scrutiny from the point of view of "equity" There seems every reason to condemn those terms being automatically improved by falling prices, although as time passes the position is complicated by the buying and selling of war loan Further where industry generally is depressed by the heavy taxation necessary to meet interest payments we have in effect all active producers penalised in the interests of those who hold old accumulations of wealth with claims to interest

It is certainly difficult to make a capital levy perfectly fair between individuals It would appear to fall most heavily on those who have accumulated as compared with those who have spent on those who work with large capital as compared with those who as barristers solicitors or actors make large incomes by their personal exertions while in any heavy tax it is difficult to avoid cases of personal hardship As far as the first point is concerned the differentiation against accumulated wealth is found in our existing taxation as well as in the levy, and it is perhaps true that some rough justification for it may be found in the exceptional circumstances which

enabled people to accumulate wealth in the last ten years The second point presents a real problem but a working solution of it might be found by imposing exceptional income tax on professional incomes for a term of years As far as cases of personal hardship are concerned the only method of avoiding them is by exempting a minimum of wealth from the levy and by graduation of the rates of tax on accumulations of capital of different size There seems no essential reason to think that the hardship would necessarily be greater than under the income tax

The question as to how far the levy is administratively practicable is vitally important The definition of the wealth to be taxed, whether and how far furniture or personal effects are to be included, or the position of those who hold capital both here and abroad, the valuation of the property even after the definition is arrived at, and the prevention of undue evasion all present technical difficulties But it is to be noticed that a levy has been imposed in Germany (the breakdown of which seems to have been due to the fluctuations of prices rather than to any inherent administrative difficulties), while the English revenue experts agreed that a special levy on war wealth was not unworkable, although the distinction between "war" and 'other' wealth would certainly have added to the difficulty of administration

It is claimed for the levy that as it would not affect future wealth its effects on production would be less bad than those of recurring taxation On the other hand, it is argued that the effect of the levy would be to shatter confidence in our economic stability and

whatever pledges were given that it would not be repeated the psychological effects would be extraordinarily bad It is not possible either to prove or disprove this It is probable that the immediate shock to confidence might be considerable, but it is more difficult to believe that experience of the positive benefit of lower taxation would not have a compensating effect

That a levy imposed on capital would necessarily reduce the capital of the country more than similar taxes on income is untrue Although the tax is imposed on capital it is likely to be met partly out of income and partly by selling existing capital and using the proceeds for payment of tax In the case of a heavy tax on income the tax is likely to be at least partly met by reducing new saving or by realising existing capital In the case of the capital levy, although many people would have to realise available capital to meet the tax the holders of war loan who would be paid out would presumably be seeking new investments and the total capital of the country would not necessarily be reduced

Any final conclusion as to the advisability of the tax must depend upon a detailed investigation of the amount that could be realised and the reduction of taxation that would result For while it might be worth risking the disturbance of the levy for a considerable return it would not necessarily be worth it for only an insignificant reduction Various estimates have been made, but the fluctuations of money values during the last years make a definite estimate impossible One point is clear The best moment for a levy would have been during the price boom which followed the end of the war Had a

levy been imposed then the inflated values and inflated money incomes would have involved the absorption of a smaller percentage of the total income the disturbance would have been less the psychological effect in the midst of the boom would have been less serious (and might even have been positively beneficial in checking over speculation) while we should have been spared the additional handicap of the heavy debt taxation when the boom and rising prices were followed by falling prices and depression A period of depression does not appear a favourable moment for a levy, partly because it might add to the existing lack of confidence, and partly because it would be an unfavourable time for the taxpayers to realise their assets to meet the necessary payments

§ 11 *A Levy on War Wealth* The suggestion for a special levy on war wealth was received with more official approval in this country than the proposal for a general levy Its great advantage was that it was intended to fall on a class from whom exceptional payments could be fairly demanded On more general grounds it seemed to present greater administrative difficulties (the experience of the E P D showed the practical difficulty of distinguishing war from other profits) while the promise of a considerable yield was less The plan was abandoned after some discussion, and even had it proved workable in 1919 or 1920 the changes since that date would now necessarily doom any attempts to assess war wealth to failure

CHAPTER X

FUTURE POLICY

§ 1 *The Present Position of Public Finance* Government finance at the present time is characterised by the extraordinary complexity of the international obligations and the enormous increase in the scale of Government spending

We dealt with the former point in the last chapter It seems probable that in 1922-23 considerable international payments will have to be made These payments will be a new factor adding to the instability of exchange rates and prices They will add to the impoverishment and increase the revenue difficulties of the debtor states and in the first instance it seems possible that they will add to the trading difficulties of the creditor countries Until some settlement of the international payments is arrived at any real solution of the exchange problem or of the internal finances of the most heavily involved states, seems impossible

Even, however, if the international position were modified to morrow by some such measure as an agreement to cancel inter allied debts the problem of enormously increased budgets would remain for most countries Many governments have as yet made no

serious attempt to meet expenditure out of taxation, and are financing post-war as they financed war expenses out of borrowing and inflation The most extreme instance is probably Russia, where in the four months December 1921, to April 1922, the Bolshevik Government issued notes to six and a half times the volume of the previous currency with the result that at the end of that period the value of the paper money had fallen to about one twentieth of its value at the beginning of December This extreme case shows the price chaos which results from great inflation, and shows further that such a policy must ultimately defeat its own ends as a method of getting revenue for the value of the Russian paper money was decreasing progressively faster than the increase in its volume and the Government had to issue more and more currency in order to get control of the same volume of purchasing power Even where a more moderate policy is adopted any borrowing must mean a postponement of a final settlement and an addition to future difficulties, while where it leads to any further inflation it is accompanied by the immediate disadvantages of fluctuating prices both at home and abroad

In Great Britain a more stringent attempt has been made since the war to balance the budget, meet current expenditure out of taxation get back to a saner monetary policy and even to reduce the accumulations of debt In the financial year, 1921–22, something like £88,000 000 was applied to the redemption of debt, and the country raised a revenue equal to five and a half times its last pre-war budget The heavy rates of tax necessary to raise the revenue were a great burden, and in the budget

of 1922 the Government abandoned the immediate attempt to reduce its capital liabilities and (with some economies in expenditure) the budget estimates were considerably reduced As a result some reductions of taxation were made the most important of which was the reduction of the Income Tax rates by a sixth Even with these allowances the budget for 1922–23 was nearly four and a half times as large as the last pre war budget

It is difficult to say how far the increase in the absolute amount of revenue needed represents a real increase in the burden of taxation for it is difficult with rapidly changing values to make an estimate of how far the National Income is above its pre war level There can, however be no reasonable doubt (and this is borne out by the great increases in the *rates* of tax) that the real burden of taxation is very much heavier than in pre war days Much of this book has attempted to show that heavy taxes must by reducing individual incomes, tend to reduce productivity for even where the best methods of taxation are adopted there is only a limited amount of unproductively used wealth which can be absorbed by taxation without injury to future production Taxes which react upon production are likely to react in one way or another on the incomes of all classes

By the end of the war taxes in this country had reached unprecedented heights After the beginning of 1920 the trade collapse the fall in prices (which was emphasised by the more stringent financial policy of the Government) and the consequent fall in incomes made the apparent burden of taxation heavier, while the delay in the payment of the direct taxes and the

system by which income tax is paid on an average of three years' profits meant that many people were paying arrears of tax on the income earned in a prosperous period, after prosperity had been succeeded by acute trade depression. The psychological effects of heavy rates of tax are undoubtedly worse in a period of depression than in a period of trade boom, and may be a serious contributory cause in delaying trade recovery. There can be little doubt that the effects of the taxes were bad, but it is important to emphasise that the collection of revenue is only one side of public finance and before making any estimate of its ill effects some attention has to be paid to the expenditure side.

§ 2. *The Debt Charges.* In the year 1922 the National Debt charges amount to £335 000 000. As there is no provision for redemption we can look for no immediate decrease in this item. We know that in the following year an additional £25,000 000 will have to be found for interest on the American debt. If there is any deficit in this year's revenue (and the margin is small) there is a prospect of new borrowing. Even apart from this possibility it seems probable that for the next years something between £325 000 000 and £350 000 000 will have to be found for interest on debt. To this has to be added a substantial sum (£90,000,000 in the current year) needed for War Pensions. This figure is likely to be only slowly reduced. Further we are at present meeting many miscellaneous expenses (including charges for demobilisation, the remaining costs of the Ministries of Munitions and Shipping and payments guaranteed to the railways and mines), which can be more or less

directly attributed to the war In other words, we are committed at present to using more than half our total revenue and considerably more than twice our total pre war revenue, to meet dead weight expenses due primarily to war In the two chief items (the interest on debt and pensions) no considerable immediate reduction is to be looked for and unless we are to look upon our debt as permanent we shall have in one way or another to find additional funds for debt redemption

The necessity of meeting this expenditure affects the whole question of the future of Government finance, but it is possible to paint our financial position too blackly As far as the interest on the internal debt is concerned the problem is (as we emphasised in earlier chapters) a question of redistribution Private incomes are reduced by the taxation but this is offset by the gain to holders of the interest bearing Government securities Our position for instance is not so bad as if we were committed to spending £300 000 000 a year on new battleships or military expeditions to Mesopotamia, for this would mean that the wealth was used for purposes which could not be expected to add to future productivity In the case of the wealth paid out as interest it is paid out to individuals who may use it just as productively as the original taxpayers Tax payments for the payments of interest on internal debt do not, as is often assumed directly reduce our capacity as a nation to contribute to future production and more especially to future saving

Indirectly, however heavy taxes used in this way do have bad results Individuals will not set their receipts from War Loan against their heavy tax payments, nor,

in the case of individuals, will the two necessarily cancel out In this way the incentives to production may be reduced And, because of this the existence of heavy taxes for interest payments must effect our attitude to all additional Government spending, for it will mean that the finding of additional funds will be more injurious than if these taxes did not exist

It may be added that just as the injury to a nation's industry from the payment of interest is partly illusory, so is the relief from the postponement of the repayment of the capital of the debt At the present time the suspension of the Sinking Fund means that the tax payers have rather more wealth, but, on the other hand, the holders of the debt who would have been otherwise paid out have less floating capital to invest The suspension does not mean that the net supply of capital in the country is increased but it does mean that the tax paying producers have to pay a smaller proportion of their incomes into the fund out of which they and other similar holders of Government debt will be repaid, and this direct relief may prove a stimulus to production In a period of trade depression such a stimulus may be worth trying in the hope of helping trade revival But as long as we are raising no surplus revenue over current expenditure we shall have to find the interest on our undiminished debt

§ 3 *The Possibilities of Increased Revenue* The outcry against taxation in 1921–22 suggests that raising additional revenue by means of additional taxes would be an unpopular and difficult proposition Income Tax at 6s in the £ seemed to have reached a point where

public opinion definitely revolted against it, and to return to that rate might have a serious effect on production, and would certainly have a considerable effect in stimulating the various methods by which the tax can be directly and indirectly evaded. Death Duties are perhaps capable of greater increases on moderate and large fortunes, although here the possibility of evasion must be borne in mind. A modification of our existing system in the direction of Professor Rignano's scheme might lead ultimately to considerable increases of yield but such a result could only be expected at the end of a considerable term of years.

As far as indirect taxes are concerned, England's traditional policy has been to concentrate on a few commodities that yield large revenues at relatively low cost. In the past this has undoubtedly proved economical as far as the costs of collection are concerned, and has had the additional advantage of leading to the minimum of interference with industry. But alcohol and tobacco are taxed to a point where a further levy would be of doubtful profit to the revenue. The Entertainments Tax hits the other luxury which is probably most widely consumed by all classes. Motoring is fairly heavily taxed for purposes of road maintenance and although it is possible that expensive cars used solely for pleasure might bear a heavier tax, any attempt to isolate special kinds of cars or cars used for special purposes means a complicated tax which would be difficult to administer. Apart from these forms of expenditure it is not easy to suggest new openings for taxation which will yield considerable revenue without encroaching upon absolutely necessary expenditure, or without undue

interference with industry If we are going to rely for very much more of our revenue upon indirect taxes, it seems almost inevitable that a heavier burden will be imposed upon the poorer classes

There is however the hope that our financial difficulties may be reduced by an increase in the yield of the present rates of tax If the trade depression continues and prices fall further this cannot happen for the reduced production due to trade stagnation means a smaller annual output of goods and services, while the falling prices mean that even the same amount of goods would represent a smaller money income If the present fall in prices and decrease in output continues our present rates of tax will have to be increased to raise the same revenue, the debt charges will absorb a larger percentage of our smaller total income and the holders of Government stock will gain at the expense of the taxpayers If trade recovers the real income of the country is likely to increase and an automatic increase in the yield of the present rates of tax will follow, but if this is accompanied by any further fall in prices the holders of Government stock will still gain at the expense of the taxpayers because of the increase in the value of their money claims on the community If the trade recovery is accompanied by a check in the fall or possibly by a moderate rise in prices, the yield of our present taxes will improve the percentage of our total income absorbed by our debt charges will be reduced and changes in the value of money will no longer be benefiting the Government stockholders at the expense of the taxpayer

The whole future of our finance is bound up with the

future of production, and anything tending to an improvement of trade will tend to increase the yield of our taxes Further, as a large part of our liabilities are fixed in terms of money our financial future is also bound up with the future of prices Any further penalisation of the taxpayer by a further fall in prices is to be deprecated—and, although we have nothing to gain from a new inflationist policy which would raise prices but almost certainly sow the seeds of another trade collapse a gentle rise of prices, which would stimulate a trade recovery, would do much to ease our present difficulties Even an immediate return to prosperity, however, would only gradually show itself in some of the revenue figures, as a considerable part of Income Tax is paid on the average of three years income, and we still have to bear part of the effect of the recent bad years in reducing tax revenue

§ 4 *The Future of Government Expenditure* The last method of meeting financial difficulties is by a strenuous cutting down of other expenditure in order to meet the heavy charges imposed by the obligations with which the war has left us More than half our present revenue is absorbed in this way Of the rest nearly £140 000 000 goes on the Army, Navy and Air Force We propose to spend £52,000 000 on education and just under £25 000 000 on public health from the national funds (together amounting to less than 9 per cent of our total expenditure) These, with the £22 000 000 absorbed by Old Age Pensions, are the chief items in the cost of our social services In addition to this of the £100 000,000 given in grants to local authorities a

large part is spent on health and education, which also absorb a considerable part of the revenue from local taxation The remainder of the revenue is absorbed by the cost of the Post Office (which is balanced by the Post Office receipts), the road fund (met out of the taxation on motoring), the charges for the various other civil services the cost of collecting revenue and the £25 000 000 allowed as a reserve for any supplementary expenses which may arise within the financial year

Government expenditure at any time is controlled by Government policy, but is largely dependent upon administrative cost The war period was a period of rapidly expanding activity, and during these years the Gladstonian tradition of turning labels on despatch boxes in the interests of economy was almost inevitably, and probably quite rightly, relaxed The increased demands on the Government undoubtedly gave openings for administrative waste The work outgrew the civil service machinery and readjustment could be only gradually made The present demand for economy is likely to lead to a tightening up of administrative expenditure and may lead to considerable economy In many cases doubtless this is desirable but if it leads either to underpayment or to understaffing the immediate economy may be dearly bought Two changes in organisation have been suggested which might result in some administrative economy The defence services might be brought under a centralised administrative control, which by co ordination might result in considerable economies in expenditure, while, secondly (as we emphasised in Chapter VII), the division of re

sponsibility between central and local authorities, and the present methods of giving grants from the central to the local funds seem to demand a long postponed revision and amplification

How far the present financial position demands a considerable change in the policy of the Government with regard to spending it is more difficult to decide The only sane way of regarding any expenditure is to balance its advantages against the cost of collecting the revenue The heavy debt charges that the Government has to meet (even although they only involve re distribution) make it more difficult to raise further funds, and in this way furnish a real argument in favour of curtailing Government expenses which might be justified if the public debts did not exist But the burden of the internal debt charges is partly illusory and may easily be exaggerated as an argument in favour of reduced expenditure

The demand for a more economical policy is directed mainly at two groups of services—the defence services and the social services The first are of course, primarily non economic and unproductive and to reduce expenditure on them would not injure productivity Recent history has shown that even the military strength of a country depends largely upon its economic and financial strength, and even from the purely military point of view some reduction of military expenditure to improve production and finance may be worth while

As far as the social services are concerned different points arise Much of the expenditure is expected to be directly or indirectly reproductive The expendi

ture has developed gradually and any considerable retrenchment now would mean not only the loss of much of the advantage of past spending but as times improved and the expenditure developed again (as it undoubtedly would) new beginnings would have to be made It is impossible to develop a good educational system or a good health system other than continuously and any curtailment for the sake of immediate economy would probably mean considerable long period waste A reduction in such expenditure as Old Age Pensions, and Unemployment Insurance would not necessarily represent a net economy to the country as a whole for the cessation of this spending would undoubtedly throw a new burden on the Poor Rate And although much has been said against the demoralising effect of the Unemployment Pay it is difficult to read the accounts of the system of relief from Poor Law and private charity in the 80's and '90's without realising that the transference of direct responsibility from the State funds would mean a considerable additional social loss Finally it should be realised that to scrap the social services to meet the interest on the war debt is a direct reversal of the policy of the last fifteen years to use taxation to reduce rather than to emphasise the differences of distribution The direct benefit of the social services goes to the poor, the holders of War Loan belong primarily to the wealthier classes To meet the payments due to the latter out of economies at the expense of the former class is, in effect, to transfer wealth from the poor to the rich Even the last budget shows some tendency in this direction, for while economies in expenditure were made that touched all classes, the bulk of the relief from taxation goes to

those income taxpayers who are liable to tax on a large proportion of their incomes

However we look at the problem the financial policy of the future must be difficult The possibility of a capital levy when prices were high was neglected and for years to come we shall have the problem of the interest and repayment of our unwieldy debt to face And although the real burden to the country as a whole is as we tried to point out largely an illusion, the difficulty of finding the revenue is a real one and may have important and disastrous effects upon distribution If a trade boom succeeds the trade depression the possibility of a levy might again become practicable Till that opportunity occurs our taxes will have to be heavy and our attitude to new expenditure more cautious than in happier circumstances